1984

Uniform CPA examination unofficial answers May 1982 to November 1983

American Institute of Certified Public Accountants. Board of Examiners

Uniform CPA Examination

May 1982 to November 1983

Unofficial Answers

AICPA American Institute of Certified Public Accountants

Uniform CPA Examination Unofficial Answers 1982-1983

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FOREWORD

The Uniform CPA Examination is prepared by the Board of Examiners of the American Institute of Certified Public Accountants and is used by the examining boards of all fifty states of the United States, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands as a prerequisite for issuance of CPA certificates. The examinations and unofficial answers are published twice a year, shortly after the May and the November examination dates.

Responding to continuing demand, we continue to publish a two volume set containing two years of examinations — May 1982 through November 1983. Questions and unofficial answers appear in separate volumes, which are published simultaneously.

Although the questions and unofficial answers may be used for many purposes, the principal reason for their publication is to aid candidates in their preparation. Candidates are also encouraged to read *Information for CPA Candidates,* which describes the content, grading and other administrative aspects of the Uniform CPA Examination.

The unofficial answers were prepared by the staff of the examinations division and reviewed by the Board of Examiners but are not purported to be official positions of the American Institute of Certified Public Accountants. Each of the unofficial answers is accompanied by its maximum point value assigned by the Board of Examiners for grading purposes.

William C. Bruschi, *Vice President-Examinations and Regulation*
American Institute of Certified Public Accountants

March 1984

Contents

Unofficial Answers to Examinations

ACCOUNTING PRACTICE—PART I

May 5, 1982; 1:30 to 6:00 P.M.

Answer 1 (10 points)

1. d	11. c
2. b	12. d
3. d	13. c
4. b	14. b
5. b	15. b
6. c	16. c
7. a	17. c
8. a	18. b
9. c	19. c
10. b	20. a

Answer 2 (10 points)

21. d	31. b
22. a	32. d
23. c	33. c
24. a	34. a
25. d	35. b
26. a	36. b
27. d	37. a
28. c	38. b
29. d	39. a
30. d	40. c

Answer 3 (10 points)

41. d	51. b
42. c	52. b
43. a	53. b
44. b	54. d
45. d	55. c
46. d	56. b
47. d	57. b
48. c	58. a
49. a	59. c
50. a	60. c

Answer 4 (10 points)

Part a.

1.

Allen, Brown, and Cox Partnership
COMPUTATION OF SAFE INSTALLMENT PAYMENTS TO PARTNERS
January 31, 1982

		Residual equities		
	Total	*Allen*	*Brown*	*Cox*
Profit and loss ratio	100%	50%	30%	20%
Computation of January installment				
Preliquidation balances				
Capital	$282,000	$118,000	$ 90,000	$74,000
Add (deduct) loans	(10,000)	(30,000)	20,000	—
	272,000	88,000	110,000	74,000
Deduct January losses (*Schedule 1*)	(28,000)	(14,000)	(8,400)	(5,600)
Predistribution balances	244,000	74,000	101,600	68,400
Deduct potential losses (*Schedule 1*)	(199,000)	(99,500)	(59,700)	(39,800)
	45,000	(25,500)	41,900	28,600
Deduct potential loss—Allen's debit balance (Brown 3/5; Cox 2/5)	—	25,500	(15,300)	(10,200)
Safe payments to partners	$ 45,000	$ 0	$ 26,600	$18,400

Schedule 1

Computation of Actual and Potential Liquidation Losses
January 1982

	Actual losses	*Potential losses*
Collection of accounts receivable ($66,000–$51,000)	$15,000	
Sale of inventory ($52,000–$38,000)	14,000	
Liquidation expenses	2,000	
Gain resulting from January credit memorandum off-set against payments to creditors	(3,000)	
Machinery and equipment, net		$189,000
Potential unrecorded liabilities and anticipated expenses		10,000
Totals	$28,000	$199,000

Part b.

Greenlaw, Inc.
JOURNAL ENTRY—SITUATION 1
December 31, 1981

	Debit	*Credit*
Magazine subscriptions collected in advance	$ 500,000	
Magazine subscriptions revenue		$500,000
To record subscriptions earned during 1981		
Liability account		
Book balance at December 31, 1981	$2,400,000	
Adjusted balance ($600,000 + $900,000 + $400,000)	1,900,000	
Credit to revenue account	$ 500,000	

Greenlaw, Inc.
SITUATION 2
December 31, 1981

No entry should be made to accrue for an expense, because the absence of insurance coverage does not mean that an asset has been impaired or a liability has been incurred as of the balance sheet date. Greenlaw may, however, appropriate retained earnings for self-insurance as long as actual costs or losses are not charged to the appropriation of retained earnings and no part of appropriation is transferred to income. The loss contingency may also be disclosed in the notes to the financial statements. Appropriation of retained earnings and/or disclosure in the notes to the financial statements are not required.

Greenlaw, Inc.
JOURNAL ENTRY—SITUATION 3
December 31, 1981

Estimated loss from pending lawsuit	$100,000	
Estimated liability from pending lawsuit		$100,000
To record estimated minimum damages on breach-of-contract litigation		

Greenlaw, Inc.
SITUATION 4
December 31, 1981

No entry should be made for this loss contingency, because it is not probable that an asset has been impaired or a liability has been incurred and the loss cannot be reasonably estimated as of the balance sheet date. The loss contingency should be disclosed in the notes to financial statements.

Answer 5 (10 points)

Part a.

1.

Hobson, Inc.
APPLICATION OF CASH RECEIPTS FROM SALE OF IDLE PLANT FACILITY TO COST RECOVERY, DEFERRED INCOME, AND INCOME RECOGNIZED UNDER THE COST RECOVERY METHOD OF ACCOUNTING
For the Period January 1, 1977, to February 1, 1981

Date	*Cash received*	*Note receivable*	*Idle plant (net)*	*Deferred income*	*Income recognized*
	Debit	*Dr. (Cr.)*	*(Credit)*	*Dr. (Cr.)*	*(Credit)*
January 1, 1977	$100,000	$600,000	$(500,000)	$(200,000)	
July 1, 1978	190,000	(100,000)		(90,000)	
December 31, 1979	275,000	(200,000)		(10,000)	$ (65,000)*
February 1, 1981	332,500	(300,000)			(32,500)
February 1, 1981				300,000	(300,000)

* Total cash received	$565,000	($100,000 + $190,000 + $275,000)
Idle plant (net)	500,000	
Income recognized	$ 65,000	

2.

Hobson, Inc.
JOURNAL ENTRY
April 1, 1981

	Debit	Credit
Machinery and Equipment ($190,000 + $30,000)	$220,000	
Land		$105,000
Gain on disposal of land ($190,000 − $105,000)		85,000
Cash		30,000
To record the exchange of land for a used printing press of Tyler Company		

Foster Corporation
COMPUTATION OF LIABILITY FOR PENSION EXPENSE NOT FUNDED REPORTED ON THE BALANCE SHEETS
As of December 31, 1980, and 1981

Past service cost amortization—1980	$29,685
Deduct past service cost funded—December 31, 1980	26,155
Liability for pension expense not funded—balance at December 31, 1980	3,530
Add interest on liability for pension expense not funded at December 31, 1980 ($3,530 × 6%)	212
Past service cost amortization—1981	29,685
	33,427
Deduct past service cost funded—December 31, 1981	26,155
Liability for pension expense not funded—balance at December 31, 1981	$ 7,272

Part b.

1.

Foster Corporation
COMPUTATION OF PENSION EXPENSE REPORTED ON THE INCOME STATEMENTS
For the Years Ended December 31, 1980, and 1981

	1980	*1981*
Normal cost	$60,000	$65,000
Past service cost	29,685	29,685
Interest on liability for pension expense not funded at December 31, 1980 ($3,530 × 6%)	—	212
Total pension expense	$89,685	$94,897

2.

Foster Corporation
COMPUTATION OF MINIMUM PENSION PROVISION
For the Year Ended December 31, 1980

Normal cost	$60,000
Interest on unfunded past service cost ($300,000 × 6%)	18,000
Minimum pension provision	$78,000

Foster Corporation
COMPUTATION OF MAXIMUM PENSION PROVISION
For the Year Ended December 31, 1980

Normal cost	$60,000
Past service cost amortization ($300,000 × 10%)	30,000
Maximum pension provision	$90,000

ACCOUNTING PRACTICE—PART II

May 6, 1982; 1:30 to 6:00 P.M.

Answer 1 (10 points)

1. c	11. a
2. c	12. d
3. a	13. c
4. a	14. a
5. b	15. a
6. d	16. d
7. d	17. d
8. b	18. c
9. c	19. a
10. c	20. b

Answer 2 (10 points)

21. a	31. a
22. a	32. c
23. a	33. a
24. c	34. c
25. b	35. a
26. c	36. d
27. a	37. b
28. c	38. b
29. a	39. c
30. d	40. d

Answer 3 (10 points)

41. b	51. d
42. d	52. b
43. a	53. a
44. a	54. d
45. c	55. c
46. b	56. c
47. c	57. a
48. d	58. b
49. c	59. a
50. a	60. c

Answer 4 (10 points)

Woodbine Circle Corporation
INCOME STATEMENT
For the Year Ended December 31, 1981

Sales		$10,000,000
Cost of sales		6,200,000
Gross profit		3,800,000
Administrative expenses		2,000,000
Operating income		1,800,000
Other income and expense		
Interest income	$100,000	
Interest expense	(210,000)	(110,000)
Income from continuing operations before income taxes		1,690,000
Income taxes (*Schedule 1*)		
Current	$576,000	
Deferred	60,000	636,000
Income from continuing operations		1,054,000
Discontinued operations (*Schedule 2*)		
Operating income from discontinued AL Division (less applicable income taxes of $264,000)	$396,000	
Loss on disposal of AL Division (less applicable income tax saving of $100,000)	(150,000)	246,000
Income before extraordinary item		1,300,000
Extraordinary item—gain on repurchase of bonds payable (less applicable income taxes of $120,000)		180,000
Net income		$1,480,000
Earnings per share		
From continuing operations		$1.054
From discontinued operations		.246*
Total before extraordinary item		1.300
From extraordinary item		.180*
Net income		$1.480

* Optional

Schedule 1

Income Taxes on Continuing Operations

Income from continuing operations before income taxes		$1,690,000
Less permanent difference—interest on municipal bonds		100,000
Balance subject to tax		$1,590,000
Income tax rate		×40%
Total income taxes on continuing operations		$ 636,000
Current		
Income per tax return		2,150,000
Less intraperiod tax allocations		
Discontinued operations		
Operating income	$660,000	
Loss on disposal	(250,000)	410,000
Extraordinary item		
Gain on repurchase of bonds payable		300,000
Current taxable income		1,440,000
Income tax rate		×40%
		$ 576,000
Deferred		
Depreciation, per tax return		750,000
Depreciation, per books		600,000
Timing difference		150,000
Income tax rate		×40%
		60,000
Total income taxes on continuing operations		$ 636,000

Schedule 2

Income From Operations of AL Division
For the Nine Months Ended September 30, 1981
(Date of Discontinuance)

Sales	$2,000,000
Cost of sales	900,000
Gross profit	1,100,000
Administrative expenses	300,000
Operating income	800,000
Interest expense	140,000
Income before income taxes	660,000
Income taxes (at 40%)	264,000
Income from operations of AL Division	$ 396,000

Answer 5 (10 points)

Part a.

		Debit	Credit
1.	By-product inventory—Nagu	$3,000	
	Work in process—Rey		$3,000
	(30,000 lbs. @ $.10/lb.)		
2.	By-product inventory—Nagu	9,000	
	Raw materials		2,000
	Direct labor		1,500
	Factory overhead		500
	Work in process—Rey		5,000
	(30,000 lbs. @ $.30/lb.)		
3.	Work in process—Nagu	4,500*	
	Work in process—Rey		4,500
	Work in process—Nagu	4,000	
	Raw materials		2,000
	Direct labor		1,500
	Factory overhead		500
	Finished goods—Nagu	8,500	
	Work in process—Nagu		8,500

*
$$\frac{30{,}000 \text{ lbs.} \times \$.10}{394{,}000 \text{ lbs.} \times \$.50 + 30{,}000 \text{ lbs.} \times \$.10} \times \$300{,}000$$

Part b.

1. *Montero Corporation*
EXPECTED CASH COLLECTIONS
May 1982

Month	*Sales*	*Percent*	*Expected collections*
March	$60,000	9	$ 5,400
April	78,000	20	15,600
May	66,000	70	46,200
Total			$67,200

2. *Montero Corporation*
EXPECTED CASH DISBURSEMENTS
May 1982

April purchases to be paid in May	$54,000
Less: 2% cash discount	1,080
Net	$52,920
Cash disbursements for expenses	14,400
Total	$67,320

3. *Montero Corporation*
EXPECTED CASH BALANCE
May 31, 1982

Balance, May 1		$22,000
Expected collections	$67,200	
Expected disbursements	67,320	(120)
Expected balance		$21,880

AUDITING

May 6, 1982; 8:30 A.M. to 12:00 M.

Answer 1 (60 points)

1. c	16. d	31. d	46. b
2. c	17. a	32. c	47. c
3. a	18. d	33. c	48. c
4. c	19. c	34. c	49. d
5. b	20. d	35. d	50. c
6. d	21. a	36. b	51. a
7. d	22. c	37. c	52. a
8. c	23. a	38. d	53. c
9. b	24. a	39. b	54. b
10. d	25. b	40. b	55. d
11. d	26. b	41. a	56. a
12. d	27. b	42. b	57. c
13. c	28. a	43. a	58. d
14. a	29. d	44. d	59. d
15. b	30. d	45. c	60. c

Answer 2 (10 points)

In order to determine whether lapping exists, Stanley would test the aging of accounts receivable and then—

- Mail positive accounts receivable confirmation requests directly to all customers with old balances.
- Investigate all exceptions noted on confirmations.
- Obtain authenticated deposit slips directly from the bank.
- Compare individual customers' names, dates, and amounts shown on the customer's remittance advices with the names, dates, and amounts recorded in the cash receipts journal, individual customer ledger accounts, and deposit slips (if practicable).
- Verify the propriety of noncash credits to accounts receivable (for example, sales discounts, sales returns, bad debt write-offs).
- Perform a surprise inspection of deposits.
- Foot the cash receipts journal, the customers' ledger accounts, and the accounts receivable control account.
- Reconcile the total of the individual customers' accounts with the accounts receivable control account.
- Compare information in copies of monthly customers' statements with information in customers' ledger accounts.

Answer 3 (10 points)

a. Accounting control comprises the plan of organization and the procedures and records that are concerned with the safeguarding of assets and the reliability of financial records.

b. A system of accounting control is designed to provide reasonable assurance that—

- Transactions are executed in accordance with management's general or specific authorization.
- Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (2) to maintain accountability for assets.
- Access to assets is permitted only in accordance with management's authorization.
- The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

c. There are inherent limitations that should be recognized in considering the potential effectiveness of any system of accounting control. In the performance of most control procedures there are possibilities for errors arising from such causes as misunderstanding of instructions, mistakes of judgment, and personal carelessness, distraction, or fatigue. Furthermore, procedures whose effectiveness depends on segregation of duties obviously can be circumvented by collusion. Similarly, procedures designed to assure the execution and recording of transactions in accordance with management's authorizations may be ineffective against either errors or irregularities perpetrated by management with respect to transactions or to the estimates and judgments required in the preparation of financial statements. In addition to the limitations discussed above, any projection of a current evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions and that the degree of compliance with the procedures may deteriorate.

Answer 4 (10 points)

a. The following information is missing:

- The date of purchase of S security
- The date of purchase and sale of R security
- Data concerning the accrual and/or receipt of interest due on R to date of sale
- Data concerning the accrual and/or payment of interest due on S to the date of purchase
- Justification for accrual of dividends
- Accounting treatment of bond discount
- Data concerning the December 31, 1980, revenue accruals
- Data required to evaluate the classification of securities

b. The following procedures were not noted as having been performed:

- The securities were not physically inspected or confirmed.
- The broker's advice (or other independent corroborating evidence) verifying the sale of R was not examined.
- Dividend rates were not verified by reference to public records (Standard & Poor's) of dividend declarations.
- The stated interest rates, maturity dates, and market values were not verified.
- Computations of year-end accruals were not made.
- Not all amounts (for example, loss on sale of R) were traced to the general ledger.

Answer 5 (10 points)

a. The assistant's report contained the following assertions that were incorrect or that should have been deleted:

- The report was addressed to Ajax but should have been addressed to Uclean.
- It indicated that an examination (of cash in banks and accounts receivable) was performed in accordance with generally accepted auditing standards.
- It indicated that tests of the accounting records and other auditing procedures were performed as considered necessary in the circumstances.
- The report contained the phrase, "in our opinion."
- It stated that cash in banks and accounts receivable were fairly presented in conformity with generally accepted accounting principles.
- It stated that cash in banks and accounts receivable were presented on a basis consistent with that of the preceding year.
- It recommended the acquisition of Ajax Corporation.

b. The assistant's report should contain the following:

- Disclaimer of opinion
- Indication that distribution of the report was to be restricted to named parties involved
- Enumeration of the procedures that were performed
- A statement of the findings
- Indication that the agreed-upon procedures were not sufficient to constitute an examination in accordance with generally accepted auditing standards
- Statement that the report applies only to the items specified
- Statement that the report does not extend to the financial statements of the company taken as a whole
- The date of the report

BUSINESS LAW

(Commercial Law)

May 7, 1982; 8:30 A.M. to 12:00 M.

Answer 1 (60 points)

1. b	16. a	31. a	46. c
2. a	17. b	32. b	47. d
3. a	18. a	33. b	48. c
4. d	19. a	34. d	49. c
5. d	20. c	35. a	50. a
6. a or b*	21. b	36. b	51. d
7. c	22. b	37. d	52. d
8. a	23. a	38. d	53. d
9. b	24. c	39. c	54. d
10. d	25. d	40. d	55. d
11. a	26. b	41. c	56. d
12. b	27. c	42. b	57. c
13. c	28. c	43. c	58. b
14. d	29. d	44. a	59. b
15. a	30. c	45. b	60. d

* Either response was accepted as correct

Answer 2 (10 points)

The impact of the registration requirements of the Securities Act of 1933 on each of the proposals is as follows:

- The offering of the participation units in the citrus groves, although ostensibly the sale of an interest in land, constitutes an offer to sell, or the sale of, securities within the meaning of section 2 of the Securities Act of 1933. Although land itself is not a security, the offering of the land in conjunction with a management contract has been held to constitute the offering of a security. Since interstate commerce and communications are to be used and since there is no apparent transactional exemption available, a registration under the 1933 act is required. Whatever hope there was of an intrastate offering exclusion is dashed by the fact that the units will be offered and sold in two states.
- The short-term borrowings evidenced by the promissory notes of Various Enterprises are exempt from registration. This exemption from categorization as a security for purposes of registration under the act applies to commercial paper such as notes, drafts, checks, and similar paper arising out of a current transaction that have a maturity not exceeding nine months. In addition, the private placement exemption is applicable.
- If Various is deemed to be a controlling person insofar as Resistance is concerned, it must register the securities in question before it can legally sell them. The Securities Act of 1933 provides in connection with its definition of the term "underwriter," that, "the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer."

  Securities Act rule 405(f) further defines the term "control." It states that "the term 'control' . . . means the possession, direct or indirect, of the power to direct or cause the direction of the policies of a person, whether through the ownership of voting securities, by contract, or otherwise." It is obvious that "control" as defined is a question of fact. In general, a controlling person has the power to influence the management and policies of the issuer. If an individual is an officer, director, or member of the executive committee, a low percentage of stock would suffice. Actual or practical control is sufficient and the power to exercise control will also be sufficient even if it is not exercised. Stock ownership is looked to and majority ownership naturally constitutes control. Although ownership of 17 percent of the stock is certainly not conclusive, it is a substantial block of stock and, if any of the above factors is also present, it would be most likely that Various would be a controlling person. Thus, although not the issuer of the stock, it would need to register the securities. This resembles a secondary offering of a large block by the owners of the corporation. This sale through the brokers will in no way insulate the transaction from registration.

Answer 3 (10 points)

Part a.

1. No. Subpoenas issued by the SEC involve the enforcement of federal law. Hence any state statutes concerned with the accountant-client privilege are not applicable. Under federal law, no privilege exists on behalf of CPAs in such proceedings.

2. No. The privilege is designed to preserve the confidentiality of communications between the client and the accountant, that is, to foster a free flow of information. However, statutory privileges may be waived. Producing two of the past ten prior-year audit files would effectively constitute a waiver of the privilege for the remaining eight.

3. Sharp may contend that the subpoenas are "overly broad" in that they call for all of his workpapers for the prior ten years where there is no evidence that Fargo engaged in questionable activities during that period. Sharp may also contend that the subpoenas are onerous or overly burdensome in that he will bear the substantial cost of duplicating the workpapers.

Part b.

Yes. Pelham & James will be found liable to Dickerson and Nichols based on their negligent misrepresentation that the trade accounts payable balance was accurate within $8,000, when in fact it was materially understated. The understatement was due to the firm's failure to detect certain unpaid bills that were available for their inspection.

It should be recognized that Pelham & James will be liable to Dickerson and Nichols even though they are third-party users of the financial statements and not in privity of contract with Pelham & James. Dickerson's and Nichols' reliance, both on the financial statements and on Pelham & James' oral representations, was specifically known, and, thus, Pelham & James owed them a duty of due care. Moreover, Pelham & James' compilation report, which disclaimed any opinion or other assurances, will not release them from liability.

Answer 4 (10 points)

Part a.

1. Craig owes nothing beyond the terms of the original contract. The fact situation poses a classic example of a preexisting legal duty. The common law rule applicable to such situations is to deny recovery for any additional amount promised if the promisee does nothing more than he was obligated to do in any event. This resolution is arrived at by finding that there is no new consideration to support the modification of the original contract. It may be helpful to think in terms of two contracts, the original contract and the modification. The use of the identical consideration present in the first contract is not legal consideration for the second contract. Some jurisdictions have attempted to mitigate the harshness of this result either by statutory provision or by a strained judicial construction of the rule by the courts. The major change has occurred by the adoption of the Uniform Commercial Code throughout the United States, but the code applies only to contracts relating to personal property.

2. Yes. The drafters of Article 2 (Sales) of the Uniform Commercial Code considered the preexisting legal duty rule to be unreasonable when applied to commercial transactions involving the purchase or sale of goods. The rule had the effect of defeating the reasonable expectations of businessmen. Code section 2-209 rejects the preexisting legal duty rule by providing as follows: "An agreement modifying a contract within this article needs no consideration to be binding." The code also provides that if the contract as modified is within the provision of the statute of frauds, the modification must be in writing. Since the modification needs no consideration and it is contained in a writing signed by the party to be charged, thus satisfying the statute of frauds, it is binding.

Part b.

Ogilvie's first asserted defense is not valid. Although there was much in Ogilvie's representations that was opinion and/or praise of the land, there were two statements of fact. One, that the land in question was virtually all splendid farmland and two, that it would be suitable for avocado growing. Neither turned out to be true. Thus, part of the first requirement for establishing fraud—a misstatement of fact—is present.

Second, Ogilvie's misstatement of fact was material to the transaction—25 percent of the land is not usable for avocado growing and has only limited utility as farmland. A substantial decrease in utility and value must be categorized as material.

Third, Ogilvie's statement that he had not lied is no defense. Although he had some basis for making a statement about the quality of the land in general, he had no basis for making the statements he made. Even if he was not aware of the facts and cannot be said to have intentionally misstated the facts, he nevertheless manifested a reckless disregard for the truth. The scienter requirement was satisfied when he made positive statements of fact without any knowledge of their truth or falsity.

The final defense asserted is based upon the reliance requirement necessary to establish fraud. Ogilvie argued that Farber's failure to inspect the land when the opportunity was available results in a bar to recovery. However, although Farber's conduct may be categorized as negligent, such conduct does not normally allow the intentional tort-feasor to escape liability. Furthermore, to allow such a defense to prevail in general would have the potential of causing and fostering fraud, particularly on the unsophisticated investor.

Answer 5 (10 points)

Part a.

No. The fading was certainly not an "Act of God," nor was it to be expected. An implied warranty regarding fitness would have existed were it not for the disclaimer. The disclaimer coupled with the parol evidence rule will prevent recovery by the purchaser for breach of warranty.

The facts pose an interesting problem whether either of the implied warranties apply. Courts might differ on whether fading would prevent the goods from being merchantable or fit for the purpose for which they were purchased. However, assuming such implied warranties do exist, they will not survive the combination of the disclaimers in conjunction with the parol evidence rule.

The parol evidence rule negates any showing of an additional express warranty, oral or written, not embodied in the contract. The language of the contract, in fact, deliberately incorporates the rule. The language is clear; it states that no additional warranty protection is afforded the buyer unless incorporated into the contract. The fourth and fifth provisions of the contract eliminate the quality warranties of merchantability and fitness and do so in the manner prescribed by section 2-316 of the Uniform Commercial Code.

Part b.

1. Yes. Wilmot's asserted legal defenses are without merit. Recovery by Nielson will be limited to 20 cents per pair, which is the difference between the contract price and the additional amount that it would have cost to purchase the goods elsewhere at the time the buyer learned of the breach. When the notice of cancellation was received, the contract price was $2.50 and the market price was $2.70.

2. No. Specific performance would not be available under the circumstances. Money damages are adequate in that it would be compensated for the amount it would have to pay to buy the goods elsewhere. Hence, it would be in as good a position as it would have been otherwise.

3. No. The Uniform Commercial Code covers these points specifically. If a seller discovers after the making of the contract, but prior to the delivery of the goods, that his customer is insolvent, he still cannot terminate the contract. However, Wilmot has the right to refuse delivery except for cash payment.

ACCOUNTING THEORY

(Theory of Accounts)

May 7, 1982; 1:30 to 5:00 P.M.

Answer 1 (60 points)

1. c	16. a	31. a	46. a
2. a	17. a	32. c	47. d
3. d	18. d	33. d	48. d
4. b	19. d	34. d	49. c
5. d	20. a	35. b	50. a
6. b	21. b	36. c	51. c
7. c	22. b	37. b	52. d
8. c	23. a	38. d	53. b
9. c	24. c	39. b	54. c
10. c	25. b	40. c	55. a
11. c	26. a	41. b	56. a
12. a	27. c	42. d	57. b
13. b	28. b	43. b	58. a
14. a	29. d	44. a	59. d
15. b	30. d	45. b	60. a

Answer 2 (10 points)

Part a.

The carrying amount of a marketable equity securities portfolio should be the lower of its aggregate cost or market value. At the end of its first year of operations, Key Company should report the current marketable equity securities portfolio in its balance sheet at cost ($500,000) and report no gain or loss in the income statement, because a gain should not be recognized until it is realized.

At the end of its second year of operations, Key Company should report the current marketable equity securities portfolio in its balance sheet at market value ($475,000) by establishing a valuation allowance and charging in the income statement the amount by which the aggregate cost exceeds the market value ($50,000). As a result, Key Company would generally need to report deferred income taxes in its balance sheet and income statement.

A realized gain ($20,000) should be reported in the income statement for the second year as a result of the sale of one security (cost $80,000) for $100,000 during the second year.

Carrying a marketable equity securities portfolio at original cost after its market value has declined has the effect of deferring recognition of the decline in the realizable value of such securities based on the expectation of a future market value recovery that may or may not occur. Because of the uncertainty of recovery, it is conservative to carry a marketable equity securities portfolio at market value when market value is below cost.

Part b.

Dynamic Company should follow the equity method of accounting for its investment in Cart Company because Dynamic Company is presumed, because of the size of its investment, to be able to exercise significant influence over the operating and financial policies of Cart Company.

In 1981, Dynamic Company should report its interest in Cart Company's outstanding capital stock as a long-term investment. Following the equity method of accounting, Dynamic Company should record the cash purchase of forty percent of Cart Company at cost, which is the amount paid.

Forty percent of Cart Company's total net income from July 1, 1981, to December 31, 1981, should be added to the carrying amount of the investment in Dynamic Company's balance sheet and shown as revenue in its income statement to recognize Dynamic Company's share of the net income of Cart Company after the date of acquisition. This amount should reflect adjustments similar to those made in preparing consolidated statements, including adjustments to eliminate intercompany gains and losses, and to amortize, if appropriate, any difference between Dynamic Company's cost and the underlying equity in net assets of Cart Company on July 1, 1981.

The cash dividends paid by Cart Company to Dynamic Company should reduce the carrying amount of the investment in Dynamic Company's balance sheet and have no effect on Dynamic Company's income statement.

As a result of following the equity method of accounting, Dynamic Company would generally need to report deferred income taxes in its balance sheet and income statement.

Answer 3 (10 points)

a. A usual but infrequently occurring charge does not meet the unusual-in-nature criterion, and, thus, it is not an extraordinary item. Therefore, it is presented appropriately in the ordinary operations section of the income statement; however, it should have been reported as a separate item rather than as part of "selling, general and administrative expenses" because it meets the criteria of being material and infrequently occurring.

An extraordinary item should not be presented in the ordinary operations section of the income statement because it is not part of the ordinary operations of Horizon Company. An extraordinary item should be presented in the income statement as a separate item, net of income taxes. The Horizon Company Statements of Income and Retained Earnings should be revised as follows:

- "Other, net" and "total costs and expenses" should be decreased by $10,000,000 to exclude the extraordinary item (charge).
- "Income before income taxes" should be increased by $10,000,000 to exclude the extraordinary item (charge) and the caption "income before income taxes" should be changed to "income before income taxes and extraordinary item (charge)."
- "Income taxes" should be increased by $5,000,000 to exclude the income tax reduction applicable to the extraordinary item (charge).
- A new caption "income before extraordinary item (charge)" should be added ($25,200,000).
- A new caption "extraordinary item (charge)" should be added showing the extraordinary item (charge) of $10,000,000, applicable income taxes of $5,000,000, and the net extraordinary item (charge) of $5,000,000.

A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error and should be reported as a prior period adjustment. Therefore, the presentation in the foregoing Horizon Company Statements of Income and Retained Earnings is appropriate.

Because of the significance attached by investors and others to earnings-per-share data, together with the importance of evaluating the data in conjunction with the financial statements, earnings per common share should be shown on the face of the income statement. Furthermore, earnings per common share for income before extraordinary items should be presented as well as earnings per common share for net income.

b. The *quick (acid-test) ratio* tests the ability to meet sudden demands upon liquid current assets.

Inventory turnover provides information about the number of times inventory is replaced each year.

The *return on stockholders' equity* indicates the percentage return accruing to the owners based upon the book value of their interest in the company.

c. The *quick (acid-test) ratio* for 1981 is determined by dividing the sum of "cash" ($3,500,000), "marketable securities" ($13,000,000), and "accounts receivable" ($105,000,000) on the Horizon Company Balance Sheet by the "total current liabilities" ($75,000,000) on the Horizon Company Balance Sheet.

Inventory turnover for 1981 is determined by dividing the "cost of goods sold" ($480,000,000) on the Horizon Company Statements of Income and Retained Earnings by the average "inventory" ($126,000,000 and $154,000,000 ÷ 2) during the year on the Horizon Company Balance Sheet. If possible, the average monthly inventory should be used.

The *return on stockholders' equity* for 1981 is determined by dividing the "net income" ($20,200,000) on the Horizon Company Statements of Income and Retained Earnings by the "total stockholders' equity" ($263,000,000) or the average "total stockholders' equity" ($263,000,000 and $255,000,000 ÷ 2) on the Horizon Company Balance Sheet.

Answer 4 (10 points)

Part a.

1. When profits or expenses are included in taxable income on the income tax return later or earlier than they are included on the income statement, a timing difference arises and deferred income taxes should be reported.

2. *Gross profits on installment sales*—Deferred income taxes would generally be recognized because gross profits on installment sales would generally be recognized in Lorac Company's income statement in the year of sale and recognized in its tax return when later collected.

Revenues on long-term construction contracts—Deferred income taxes could be recognized because revenues on long-term construction contracts could be recognized in Lorac Company's income statement on the percentage-of-completion basis and recognized in its tax return on the completed-contract basis.

Estimated costs of product warranty contracts—Deferred income taxes should be recognized because estimated costs of product warranty contracts should be recognized in Lorac Company's income statement in the year of sale and recognized in its tax return when paid.

Premiums on officers' life insurance with Lorac as beneficiary—This is a permanent difference and deferred income taxes should not be recognized. Premiums on officers' life insurance with Lorac as beneficiary should be recognized in Lorac Company's income statement but are not a deductible expense in its tax return.

Part b.

Deferred income taxes related to a noncurrent asset or liability would be classified as a noncurrent item in the balance sheet. Deferred income taxes are related to an asset or liability if reduction of the asset or liability causes the timing difference to reverse.

Deferred income taxes that are not related to an asset or liability because (*a*) there is no associated asset or liability or (*b*) reduction of an associated asset or liability will not cause the timing difference to reverse would be classified based on the expected reversal date of the specific timing difference. An expected reversal date beyond one year (or the normal operating cycle) would require noncurrent classification of the deferred income taxes.

Deferred income taxes would be classified in the balance sheet as a noncurrent liability when the noncurrent deferred credits related to timing differences exceed the noncurrent deferred charges related to timing differences. Conversely, they would be classified in the balance sheet as a noncurrent asset when the noncurrent deferred charges related to timing differences exceed the noncurrent deferred credits related to timing differences.

Answer 5 (10 points)

Part a.

An objective in selecting the base for Stein Company's predetermined annual factory overhead rate is to ensure the application of factory overhead in reasonable proportion to a beneficial or causal relationship to products. Ordinarily, the base selected should be closely related to functions represented by the applied overhead cost. If factory overhead costs are predominantly labor oriented, such as supervision and indirect labor, the proper base would probably be direct labor hours. If factory overhead costs are predominantly related to the costs incurred in the ownership and operation of the machinery, the proper base would probably be machine hours.

Another objective in selecting the base is to minimize clerical cost and effort relative to the benefits attained. When two or more bases provide approximately the same applied overhead cost to specific units of production, the simplest base should be used.

A predetermined annual factory overhead rate provides a feasible method of computing product costs promptly enough to serve management needs, such as identifying inefficiencies and minimizing month-to-month distortions in unit costs created by uneven expenditure patterns.

Part b.

1. A factory overhead variance analysis report provides periodic identification of deviations from planned outcomes. It provides a basis for further analysis, investigation, and follow-up action. It is useful in developing budgets and standards for future operations. Variances can be used to identify changes in operations that need to be reflected in such activities as product pricing, compensation rates, maintenance levels, and so forth. The report can be helpful in identifying costs incurred that should be classified as losses rather than product costs.

2. The two-variance method breaks down the overall factory overhead variance—that is, the difference between the actual factory overhead and the factory overhead applied to production—into two components. They are (*a*) the controllable (budget) variance and (*b*) the volume (denominator) variance.

The controllable (budget) variance is the difference between the actual factory overhead and the budget allowance based on standard hours allowed. The department managers have the responsibility to exercise control over the costs to which the variances relate.

The volume (denominator) variance is the difference between the budget allowance based on standard hours allowed and the factory overhead applied to production. The variance indicates the cost of capacity available but not utilized or not utilized efficiently, and such variance is generally considered the responsibility of management.

ACCOUNTING PRACTICE—PART I

November 3, 1982; 1:30 P.M. to 6:00 P.M.

Answer 1 (10 points)

1. c
2. b
3. d
4. a
5. c
6. d
7. b
8. a
9. a
10. b
11. c
12. b
13. a
14. c
15. c
16. c
17. b
18. a
19. a
20. d

Answer 2 (10 points)

21. c
22. a
23. d
24. a
25. a
26. d
27. d
28. c
29. b
30. d
31. c
32. c
33. d
34. c
35. b
36. c
37. a
38. b
39. c
40. b

Answer 3 (10 points)

41. a
42. c
43. b
44. d
45. d
46. b
47. b
48. a
49. c
50. d
51. b
52. b
53. c
54. c
55. c
56. a
57. c
58. b
59. b
60. d

The scores for the multiple choice questions were determined in accordance with the following scales:

Answer 1

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10	10

Answer 2

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10

Answer 3

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10	10	10

Answer 4 (10 points)

Farrell Corporation
STATEMENT OF CHANGES IN FINANCIAL POSITION WORKSHEET (CASH BASIS)
For the Year Ended December 31, 1981
(Not Required)

Assets	*1980*	*Dr.*	*Cr.*	*1981*
Cash	$ 180,000	(x) $ 95,000		$ 275,000
Accounts receivable	305,000		(7) 10,000	295,000
Inventories	431,000	(8) 118,000		549,000
Investment in Hall, Inc.	60,000	(5) 13,000		73,000
Land	200,000	(10) 150,000		350,000
Plant and equipment	606,000	(15) 63,000	(4) 45,000	624,000
Less accumulated depreciation	(107,000)	(4) 21,000	(2) 53,000	(139,000)
Goodwill	20,000		(3) 4,000	16,000
Total assets	$1,695,000			$2,043,000
Liabilities and stockholders' equity				
Accounts payable and accrued expenses	$ 563,000		(9) 41,000	$ 604,000
Note payable, long-term	—		(10) 150,000	150,000
Bonds payable	210,000	(12) 50,000		160,000
Deferred income taxes	30,000		(6) 11,000	41,000
Common stock	400,000		(11) 10,000	430,000
			(12) 20,000	
Additional paid-in capital	175,000		(11) 13,000	226,000
			(12) 30,000	
			(13) 8,000	
Retained earnings	334,000	(14) 43,000	(1) 141,000	432,000
Treasury stock	(17,000)		(13) 17,000	—
Total liabilities and equity	$1,695,000	$553,000	$553,000	$2,043,000

Sources of Financial Resources	*Sources*	*Uses*
Cash provided by operations		
Net Income	(1) $141,000	
Depreciation	(2) 53,000	
Amortization of goodwill	(3) 4,000	
Loss on sale of equipment	(4) 5,000	
Equity in net income of Hall, Inc.	(5) (13,000)	
Deferred income taxes	(6) 11,000	
Decrease in accounts receivable	(7) 10,000	
Increase in inventories	(8) (118,000)	
Increase in accounts payable and accrued expenses	(9) 41,000	
	134,000	
Issuance of note payable to purchase land	(10) 150,000	
Sale of equipment	(4) 19,000	
Sale of common stock	(11) 23,000	
Issuance of common stock to convert bonds	(12) 50,000	
Sale of treasury stock	(13) 25,000	
Uses of Financial Resources		
Cash dividends		(14) $ 43,000
Conversion of bonds to common stock		(12) 50,000
Purchase of land by issuance of note		(10) 150,000
Purchase of equipment		(15) 63,000
Increase in cash		(x) 95,000
	$401,000	$401,000

Farrell Corporation
STATEMENT OF CHANGES IN FINANCIAL POSITION (CASH BASIS)
For the Year Ended December 31, 1981

Financial resources provided		
Cash provided by operations		
Net income		$141,000
Add (or deduct) items not affecting cash		
Depreciation	$ 53,000	
Amortization of goodwill	4,000	
Loss on sale of equipment	5,000	
Equity in net income of Hall, Inc.	(13,000)	
Deferred income taxes	11,000	
Decrease in accounts receivable	10,000	
Increase in inventories	(118,000)	
Increase in accounts payable and accrued expenses	41,000	(7,000)
		134,000
Cash from other sources		
Sale of equipment		19,000
Sale of common stock		23,000
Sale of treasury stock		25,000
Financial resources not affecting cash		
Issuance of note payable to purchase land		150,000
Issuance of common stock to convert bonds		50,000
Total financial resources provided		401,000
Financial resources used		
Cash dividends		43,000
Purchase of equipment		63,000
Financial resources not affecting cash		
Conversion of bonds to common stock		50,000
Purchase of land by issuance of note		150,000
Total financial resources used		306,000
Increase in cash		$ 95,000

Answer 5 (10 points)

Part a.

1. *Tully Corporation*
INTANGIBLES SECTION OF BALANCE SHEET
December 31, 1981

Franchise from Rapid Copy Service, Inc., net of accumulated amortization of $6,870 (*Schedule 1*)	$ 61,830
Patent, net of accumulated amortization of $2,050 (*Schedule 2*)	14,350
Trademark, net of accumulated amortization of $7,294 (*Schedule 3*)	42,706
Total intangibles	$118,886

Schedule 1

Computation of Franchise from Rapid Copy Service, Inc.

Cost of franchise at January 1, 1981	
Down payment	$ 25,000
Present value of installments	43,700
Initial amount capitalized	68,700
Amortization of franchise for 1981 ($68,700 ÷ 10 years)	(6,870)
Franchise balance, December 31, 1981	$ 61,830

Schedule 2

Computation of Patent

Capitalized cost of patent at January 2, 1981—legal fees and other costs associated with registration	$ 16,400
Amortization of patent for 1981 ($16,400 ÷ 8 years)	(2,050)
Patent balance, December 31, 1981	$ 14,350

Schedule 3

Computation of Trademark

	Cost	Accumulated amortization
Cost of trademark at July 1, 1978	$40,000	
Amortization through December 31, 1980 ($40,000 ÷ 20 years = $2,000 × 2½ years)		$5,000
Amortization for period January 1–June 30, 1981 ($2,000 × ½)		1,000
Cost of successful litigation in defense of trademark, July 1, 1981	10,000	
Balance, July 1, 1981	50,000	6,000
Amortization for period July 1–December 31, 1981 ($50,000 − $6,000 = $44,000 trademark balance ÷ 17 year remaining life = $2,588 × ½)		1,294
Balance, December 31, 1981	50,000	$7,294
Deduct accumulated amortization	7,294	
Trademark balance, December 31, 1981	$42,706	

2. *Tully Company*
EXPENSES RESULTING FROM INTANGIBLES TRANSACTIONS
For the Year Ended December 31, 1981

Franchise from Rapid Copy Service, Inc.	
Amortization of franchise (*Schedule 1*)	$ 6,870
Franchise fee on revenues from operations ($900,000 × 5%)	45,000
Imputed interest expense on unpaid balance of initial franchise fee ($43,700 × 14%)	6,118
	57,988
Amortization of patent (*Schedule 2*)	2,050
Amortization of trademark ($1,000 + $1,294) (*Schedule 3*)	2,294
Total expenses	$ 62,332

Part b.

1. *Brock Corporation*
LAND ACCOUNT (SITE NUMBER 101)
As of September 30, 1981

Acquisition cost	$600,000
Real estate broker's commission	36,000
Legal fees	6,000
Title guarantee insurance	18,000
Cost of razing existing building	75,000
Balance, September 30, 1981	$735,000

2. *Brock Corporation*
CAPITALIZED COST OF OFFICE BUILDING
As of September 30, 1981

Contract cost	$3,000,000
Plans, specifications and blueprints	12,000
Architects' fees for design and supervision	95,000
Capitalized interest—1980 ($900,000 × 14% × 10/12)	105,000
Capitalized interest—1981 ($2,300,000 × 14% × 9/12)	241,500
Total capitalized cost, September 30, 1981	$3,453,500

3. *Brock Corporation*
COMPUTATION OF DEPRECIATION OF OFFICE BUILDING USING 150% DECLINING BALANCE METHOD
For the Year Ended December 31, 1981

Capitalized cost	$3,453,500
150% declining balance rate (100% ÷ 40 years = 2.5% × 1.5)	×3.75%
Annual depreciation	$ 129,506
Depreciation October 1 to December 31, 1981 ($129,506 × 3/12)	$ 32,377

ACCOUNTING PRACTICE—PART II

November 4, 1982; 1:30 P.M. to 6:00 P.M.

Answer 1 (10 points)

1. b
2. b
3. d
4. c
5. c
6. a
7. a
8. d
9. c
10. a
11. b
12. a
13. b
14. b
15. c
16. c
17. c
18. a
19. d
20. c

Answer 2 (10 points)

21. b
22. a
23. c
24. c
25. c
26. b
27. a
28. c
29. a
30. d
31. a
32. a
33. d
34. c
35. b
36. b
37. c
38. c
39. a
40. c

Answer 3 (10 points)

41. b
42. a
43. d
44. d
45. c
46. b
47. d
48. c
49. c
50. b
51. a
52. c
53. c
54. b
55. b
56. d
57. c
58. b
59. a
60. d

The scores for the multiple choice questions were determined in accordance with the following scales:

Answer 1

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10

Answer 2

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	½	1	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10

Answer 3

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10	10

Answer 4 (10 points)

1.

Howe Corporation
COMPUTATION OF NET DEDUCTIONS FOR TAX REPORTING PURPOSES GIVING RISE TO INTERPERIOD TAX ALLOCATION ON ORDINARY INCOME
For the Years Ended December 31

	1979	*1980*	*1981*
Depreciation—packaging equipment			
($450,000 − $60,000) × 5/15	$130,000		
($450,000 − $60,000) × 4/15		$104,000	
($450,000 − $60,000) × 3/15			$78,000
Patent amortization ($68,000 ÷ 17)			4,000
Total deductions	130,000	104,000	82,000
Less rental income		120,000	
Net deductions for income tax reporting	$130,000	$(16,000)	$82,000

NOTE: Investment credit is ignored in computing interperiod tax allocation.

2.

Howe Corporation
COMPUTATION OF NET DEDUCTIONS FOR FINANCIAL STATEMENTS ADJUSTED FOR PERMANENT DIFFERENCE GIVING RISE TO INTERPERIOD TAX ALLOCATION ON ORDINARY INCOME
For the Years Ended December 31

	1979	*1980*	*1981*
Depreciation—packaging equipment, based on cost less salvage value, before offset of investment credit			
($450,000 − $60,000) ÷ 5	$78,000	$78,000	$78,000
Patent amortization ($68,000 ÷ 4)			17,000
Total deductions	78,000	78,000	95,000
Less rental income ($120,000 ÷ 3)		40,000	40,000
Net deductions for financial statements as adjusted	$78,000	$38,000	$55,000

3.

Howe Corporation
COMPUTATION OF DEFERRED TAX CREDIT AT CAPITAL GAINS RATE
At December 31, 1981

Gain on sale of land for financial reporting purposes ($400,000 − $300,000)	$100,000
Gain on sale of land for tax reporting purposes ($400,000 − $300,000) ÷ 10	10,000
Deferred gain for tax reporting purposes	90,000
Capital gains rate	×28%
Deferred tax credit at capital gains rate	$ 25,200

4.

Howe Corporation
COMPUTATION OF TOTAL NET DEFERRED TAX CREDITS (DEBITS)
At December 31

	1979	*1980*	*1981*
Timing differences taxed at ordinary rates:			
Net deductions for income tax purposes	\$130,000	\$(16,000)	\$82,000
Net deductions for financial statement purposes as adjusted	78,000	38,000	55,000
Tax deductions in excess of financial statement deductions	52,000	(54,000)	27,000
Tax rate on ordinary income	×40%	×40%	×40%
Deferred tax credits (debit) at ordinary rates	20,800	(21,600)	10,800
Deferred tax credit at 28% capital gains rate			25,200
Total net deferred tax credits (debit)	20,800	(21,600)	36,000
Cumulative total deferred tax credits	\$ 20,800	\$ (800)	\$35,200

5.

Howe Corporation
COMPUTATION OF TOTAL INCOME TAX EXPENSE FOR FINANCIAL STATEMENT PURPOSES
For the Years Ended December 31

	1979	*1980*	*1981*
Income taxes per tax returns	\$ 50,000	\$142,400	\$101,280
Add investment credit	30,000		
Income taxes before investment credit	80,000	142,400	101,280
Add deferred tax credits (debit)	20,800	(21,600)	36,000
Total income tax expense before investment credit	100,800	120,800	137,280
Less amortization of investment credit	6,000	6,000	6,000
Total income tax expense	\$ 94,800	\$114,800	\$131,280

Answer 5 (10 points)

1.

Glendora Hospital
STATEMENT OF REVENUES AND EXPENSES
For the Year Ended June 30, 1982

Patient service revenue (*Notes A and B*)		$16,000,000
Allowances and uncollectible accounts (*Note A*)		(3,400,000)
Net patient service revenue		12,600,000
Other operating revenue (including $160,000 from specific purpose funds)		346,000
Total operating revenue		12,946,000
Operating expenses (including provision for depreciation of $500,000; *Notes A, B, and C*)		13,370,000
Loss from operations		(424,000)
Nonoperating revenue:		
Unrestricted gifts and bequests (*Note A*)	$410,000	
Unrestricted income from endowment funds	160,000	
Income from board-designated funds	82,000	
Total nonoperating revenue		652,000
Excess of revenues over expenses		$ 228,000

See accompanying Notes to Financial Statements.

2. *Glendora Hospital*
NOTES TO FINANCIAL STATEMENTS

Note A—Summary of Significant Accounting Policies

Patient service revenue

Patient service revenue is accounted for at established rates on the accrual basis. Revenue under cost reimbursement agreements is subject to audit and retroactive adjustment by third-party payors. Estimated retroactive adjustments under these agreements are included in allowances.

Gifts and bequests

Gifts and bequests are recorded at fair market values when received.

Provision for depreciation

Depreciation of property, plant, and equipment is computed on a straight-line basis over the estimated useful lives of the individual assets. However, accelerated depreciation is used to determine reimbursable costs under certain third-party reimbursement agreements. Net cost reimbursement revenue resulting from the difference in depreciation methods is deferred.

Pension costs

Accrued pension costs are funded currently. Prior service cost is amortized over a period of twenty years.

Note B—Cost Reimbursement Agreements

Revenue of $6 million was recognized under cost reimbursement agreements. The net cost reimbursement revenue resulting from the difference in depreciation methods described in Note A amounted to $220,000 and was deferred.

Note C—Pension Costs

Operating expenses include pension costs of $100,000 in connection with a noncontributory pension plan covering substantially all employees. The actuarially computed value of vested and nonvested benefits at year end amounted to $3 million and $350,000, respectively. The assumed rate of return used in determining the actuarial present value of accumulated plan benefits was 8%. The plan's net assets available for benefits at year end was $3,050,000.

AUDITING

November 4, 1982; 8:30 A.M. to 12:00 M.

Answer 1 (60 points)

1. d
2. c
3. d
4. b
5. b
6. c
7. b
8. d
9. a
10. c
11. a
12. d
13. a
14. b
15. c
16. c
17. c
18. b
19. b
20. a
21. c
22. d
23. c
24. c
25. a
26. a
27. b
28. d
29. c
30. d
31. a
32. d
33. a or c*
34. c
35. a
36. d
37. d
38. d
39. c
40. c
41. b
42. c
43. b
44. c
45. a
46. c
47. a
48. b
49. b
50. b
51. a
52. d
53. d
54. a
55. d
56. b
57. b
58. a
59. c
60. d

*Either response was accepted as correct.

The score for the multiple choice question was determined in accordance with the following scale:

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21

Correct	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40
Score	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40	41

Correct	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60
Score	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60	60

Answer 2 (10 points)

a. The remaining steps are as follows:

4. Define the attributes (characteristics) of interest to be tested (including the criteria for establishing the existence of errors or deviant conditions).
5. Set the maximum rate of deviations from a prescribed control procedure that would support the planned reliance on the control (tolerable rate).
6. Select a confidence level (quantify the risk of overreliance).
7. Estimate the population error rate (deviation rate).
8. Determine the sample size.
9. Choose a method for randomly selecting a sample.
10. Perform the compliance audit procedures.
11. Perform error analysis (calculate the deviation rate and consider the qualitative aspects of the deviations).
12. Interpret sample results (calculate a population deviation rate).
13. Decide on the acceptability of the results of the sample.

b. Statistical sampling methodology helps the auditor (1) to design an efficient sample, (2) to measure the sufficiency of the evidential matter obtained, and (3) to evaluate the sample results. By using a statistical sampling methodology, the auditor can quantify sampling risk to assist in limiting it to an acceptable level.

Answer 3 (10 points)

The system of internal control should provide for—

- Drivers to count and then sign for all merchandise received.
- Daily verification of each driver's ending inventory.
- Cash to be deposited daily by each driver.
- Daily return of duplicate deposit slips by each driver.
- Reconciliation of cash deposits with the daily net change in inventory.
- Provision for explanation of overages and shortages.
- A periodic independent surprise check of machines to verify that—
  - **a.** Machines contain only authorized Trapan-purchased merchandise.
  - **b.** Machines are mechanically programmed to charge the authorized prices.
  - **c.** Cash and merchandise in machines equal a predetermined (imprest) total.
- Bonding of employees.
- Alternate driver routes and required vacations.
- Restricting access to the warehouse.
- The warehouseman to count and sign for all items going into or out of the warehouse.
- Maintenance of perpetual inventory records.
- Periodic physical inventory count of merchandise in the warehouse.
- Analytical review of collections.

Answer 4 (10 points)

a. The procedures that Andrews should employ in examining the loans are as follows:

- Obtain an understanding of the business purpose of the loans made by the president.
- Confirm the loans, including terms, by direct communication.
- Recompute (or verify) interest expense and interest payable.
- Recompute the long-term and short-term portions of the debt.
- Review minutes of meetings of the board of directors for proper authorization.
- Verify payments made during the year and transactions after the year end.
- Read (notes to) the financial statements and the loan agreements, and evaluate the adequacy of disclosure and compliance with restrictions.
- Obtain a management representation letter.

b. Broadwall's financial statements should disclose the following information concerning the loans from its president:

- The nature of the related-party relationship
- The dollar amounts of the loans
- Amounts due the president and, if not otherwise apparent, the terms and manner of settlement

Answer 5 (10 points)

To: The Board of Directors of Tillis Ltd.

We have reviewed the accompanying balance sheet of Tillis Ltd. as of December 31, 1981, and the related statements of income, retained earnings, and changes in financial position for the year then ended, in accordance with standards established by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of Tillis Ltd.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an examination in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying 1981 financial statements in order for them to be in conformity with generally accepted accounting principles.

The financial statements for the year ended December 31, 1980, were examined by us, and we expressed an unqualified opinion on them in our report dated February 27, 1981, but we have not performed any auditing procedures since that date.

March 3, 1982 Novak & Co.

BUSINESS LAW

(Commercial Law)

November 5, 1982; 8:30 A.M. to 12:00 M.

Answer 1 (60 points)

1. a
2. b
3. c
4. d
5. c
6. d
7. a
8. a
9. a
10. b
11. b
12. b
13. a
14. d
15. b
16. a
17. c
18. b
19. b
20. d
21. a
22. a
23. b
24. c
25. b
26. a
27. d
28. b
29. d
30. c
31. c
32. a
33. c
34. c
35. b
36. b
37. c
38. c
39. b
40. c
41. c
42. d
43. c
44. c
45. b
46. d
47. c
48. a
49. b
50. b
51. c
52. b
53. d
54. b
55. a
56. c
57. a
58. c
59. c
60. a

The score for the multiple choice question was determined in accordance with the following scale:

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29	30

Correct	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40
Score	31	32	33	34	35	36	37	38	39	40	41	42	43	44	45	46	47	48	49	50

Correct	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60
Score	51	52	53	54	55	56	57	58	59	60	60	60	60	60	60	60	60	60	60	60

Answer 2 (10 points)

Part a.

1. Yes. Section 32 (a) of the Securities Exchange Act of 1934 provides that any person who "willfully" violates a substantive provision of the 1934 act or any person who "willfully and knowingly" makes, or causes to be made, false or misleading statements in reports required to be filed with the SEC shall be subject to criminal sanctions. The elements of the government's case would be (1) falsity, that is, the false information included in the Form 10-K; (2) of a "material" fact, satisfied here based on the facts; and (3) criminal intent, as evidenced by the acceptance of the additional $20,000 fee by Danforth as payment for not mentioning the CD in his report. To prove criminal intent, it need only be established that Danforth rendered his opinion knowing that the financial statements were false.

2. Yes. The fact that Danforth can establish that no one was damaged will not be a valid defense to the criminal action. The reason is that such damage is not an element of proof in criminal proceedings.

Part b.

Yes. Danforth would be found liable to the bank. According to the facts, the bank made the loan to Blair in reliance on the audit report and financial statements. Danforth's failure to disclose the subsequently discovered information to the bank, constituted a common law fraud. Danforth had a duty to correct the financial statements, which he knew to be in error and which he knew the bank would rely upon. The necessary fraudulent intent of the auditor may be inferred where, as here, the auditor sits by silently while others rely on his original representations.

Danforth's performance of his audit in accordance with GAAS did not relieve him of his responsibility to disclose to the bank the fact that the CD was erroneously included in the financial statements. The auditor owes such a duty to third parties, the breach of which constitutes an intentional misrepresentation rather than mere negligence.

Answer 3 (10 points)

Part a.

Yes. The shareholders will succeed. Directors and officers are fiduciaries and consequently must exercise the utmost good faith in respect of their corporation. If a "corporate opportunity" arises, they are required to offer the opportunity to the corporation. Generally a corporate opportunity will be found to exist if

- a director or officer becomes aware of the opportunity in his corporate capacity, or
- the opportunity relates to the business of the corporation.

The facts clearly indicate that such a corporate opportunity did exist, and thus the new yogurt opportunity should have been offered to Billings in the first instance. As a fiduciary, such an offer was necessary prior to exploitation of the opportunity by Harrelson. Moreover, Harrelson's use of corporate credit and personnel was a further violation of his fiduciary obligation. Accordingly, Billings' shareholders will prevail in their action. The remedy will include the holding of the Wexler stock in constructive trust for Billings, as well as possible damages against Harrelson for his personal use of corporate employees and credit.

Part b.

1. Graham's spouse would lose in such an action. One of the principal characteristics of a tenancy in partnership is that upon the death of a partner, that partner's right in specific partnership property vests in the surviving partner or partners. Another characteristic provides that a partner's right in specific partnership property is not subject to dower, curtesy, or allowances to a surviving spouse, heirs, or next of kin.

2. Yes. Despite the fact that legal title to the real estate remains with Phillips, this is not conclusive evidence that the real estate is not a partnership asset. This is a factual question in which the objective intention of the parties may be inferred by examining a variety of factors such as whether the property was improved with partnership funds, whether expenses relating to the asset (such as insurance and taxes) were paid for by the partnership, and so forth. Since the partnership actually paid the real estate taxes, such property may properly be considered a partnership asset and thus included on its balance sheet.

3. No. Jamison may attach Killian's partnership interest in the firm by obtaining a charging order (which would, for example, entitle Jamison to receive Killian's share of the partnership profits) but cannot obtain a fractional interest in any specific item of property.

4. No. The act of every partner for apparently carrying on in the usual course the business of the partnership binds the partnership, unless the partner so acting has in fact no authority and the person with

whom he is dealing has knowledge of the lack of authority. The acts of Henderson appeared to be in the usual course of business, and there is no indication that the purchaser knew of Henderson's lack of authority. Accordingly, the partnership is bound.

Answer 4 (10 points)

Part a.

No. The question of the status of franchised dealerships containing territorial restrictions on where the franchised dealer may sell has appeared before the Supreme Court twice in recent times. Despite its utility and widespread use as a marketing device for manufacturers, it had previously been held to be illegal per se if title to the goods had passed to the buyer, as in this fact situation.

The Supreme Court subsequently overruled its prior decision and held that vertical territorial marketing restrictions are to be tested in accordance with their economic effect. The Court believed that such restrictions do not always lack any redeeming value, since they may actually promote interbrand competition. Accordingly, it overruled the per se rule and held that a rule-of-reason standard is applicable.

Part b.

1. No. The Model Business Corporation Act provides that any person who has held stock for at least six months or owns at least 5 percent of the stock has the right to examine and make extracts of the list of shareholders for any proper purpose. Proper purpose includes ousting the existing management. Since Powell owns 5 percent of the stock, it qualifies under this provision. If Baron refuses such access, Baron is liable to Powell for a penalty of 10 percent of the value of the stock held by Powell in addition to any other damages or remedy afforded by law.

2. Baron, having a class of securities regulated under the act, must either provide a list of shareholders or mail the proxy materials of the insurgents to the corporation's shareholders. The expense of this mailing must be assumed by the insurgents.

3. Pursuant to the rules and regulations promulgated under section 14 of the Securities Exchange Act of 1934, the SEC has required that

- Proxy material must disclose all material facts on matters to be voted upon in order to enable shareholders to vote intelligently.
- Where control is at issue, names and interests of all participants must be disclosed.
- The proposed proxy material must be submitted for advance review by the SEC.
- Proxy materials must be distributed to the shareholders of record.

Answer 5 (10 points)

Part a.

1. The recoverable loss is determined by reference to the following formula:

$$\frac{\text{Insurance carried}}{\text{Insurance required}} \times \text{the amount of the loss}$$

where the insurance required is defined as the value of the property at the time of the loss multiplied by the coinsurance percentage. Applying the foregoing formula, the amount of the loss recovered is as follows:

$$\frac{\$600{,}000}{\$1{,}000{,}000 \times .8} \times \$200{,}000 = \$150{,}000.$$

2. The \$150,000 will be distributed as follows: \$106,000 to Second National and \$44,000 to Jackson. This is because Second National's insurable interest equals the extent of its mortgage outstanding, which is limited to debt outstanding plus accrued interest, and is paid first. The remaining \$44,000 would then be paid to Jackson.

3. Jackson will recover \$300,000—the face amount of the policy. The coinsurance clause does not apply to a total loss.

4. Jackson will recover \$45,000. The formula for determination of the total amount recoverable under the 80% coinsurance clause is as follows:

$$\frac{\$150{,}000}{\$250{,}000 \times .8} \times \$60{,}000 = \$45{,}000.$$

5. Jackson will recover \$30,000 from Queen. This amount is determined as follows:

$$\frac{\$100{,}000 \text{ (Queen's coverage)}}{\$150{,}000 \text{ (Total coverage)}} \times \$45{,}000 = \$30{,}000.$$

Part b.

Based upon the facts of the problem and the legal criteria discussed below, it appears that the manufacturing machinery retains its character as personalty and therefore can be removed by Darby at the expiration of the building lease and is properly being depreciated over its estimated useful life of thirty years. The central air conditioning system, however, appears to be realty and therefore cannot be removed by Darby at the expiration of the building lease. It should therefore be depreciated by Darby over the term of the lease, that is, twenty years.

In order to determine the rightful ownership of the central air conditioning system and the manufacturing machinery upon expiration of the building lease, one needs to determine if either or both should be regarded as realty by virtue of being fixtures. Whether a particular item of personalty becomes a fixture depends on whether there has been an annexation to the realty and an intention that the item become a fixture. The intention is inferred from such matters as (1) the nature of the item, (2) the manner of its attachment to the realty, and (3) the possible injury to the realty that might be caused by its removal.

In Darby's case, both the central air conditioning system and the machinery would likely be fixtures under this analysis. However, when personal property is attached to realty for the particular purpose of increasing the business profits of a tenant during a lease term, such personal property is ordinarily classified as a trade fixture. The manufacturing machinery clearly fits into this category, since it is directly used to increase Darby's business profits. A trade fixture may be removed by the lessee unless it is so built into the realty that it becomes an integral part thereof. Accordingly, if it can be removed at the building's lease term with no material damage to the building, it may be removed.

It is unlikely that the central air conditioning system would be considered to be a trade fixture. Thus, it is subject to the general rules applicable to fixtures discussed above. As a result, it has become realty and cannot be removed at the end of the lease.

ACCOUNTING THEORY

(Theory of Accounts)

November 5, 1982; 1:30 P.M. to 5:00 P.M.

Answer 1 (60 points)

1. b
2. d
3. c
4. d
5. a
6. c
7. c
8. d
9. b
10. c
11. d
12. c
13. c
14. b
15. b
16. c
17. c
18. c
19. b
20. d
21. c
22. c
23. c
24. b
25. a
26. d
27. a
28. a
29. a
30. b
31. a
32. a
33. d
34. a
35. c
36. c
37. d
38. a
39. a
40. c
41. d
42. b
43. a
44. c
45. b
46. b
47. d
48. a
49. d
50. d
51. d
52. a
53. a
54. b
55. a
56. b
57. b
58. d
59. c
60. a

The score for the multiple choice question was determined in accordance with the following scale:

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24

Correct	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40
Score	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40	41	42	43	44

Correct	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60
Score	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60	60	60	60	60

Answer 2 (10 points)

Part a.

1. Carme Company should report a portion of the interest income from the note receivable in 1981 (interest earned for the six-month period from July 1, 1981, to December 31, 1981) and a portion in 1982 (interest earned for the six-month period from January 1, 1982, to June 30, 1982). Interest accrues with the passage of time, and thus it should be accounted for as an element of income over the life of the note receivable.

2. First, determine the maturity value of the note receivable (the face value of the note receivable plus the interest income to be earned over the life of the note receivable [twelve-month period from July 1, 1981, to June 30, 1982]). Then, multiply the maturity value of the note receivable by one half of the discount rate (six-month period from December 31, 1981, to June 30, 1982) to arrive at the amount of the discount.

To account for the discounting transaction, cash would be debited for the amount received from the bank. Notes receivable would be credited for the face value of the note receivable. Interest expense for the amount of the discount would be debited and interest revenue for the interest income to be earned over the life of the note receivable would be credited. These latter two entries, however, are usually netted against each other instead of being recognized separately.

Part b.

1. The allowance method based on credit sales attempts to match bad debts with the revenues generated by the sales in the same period. Thus, it focuses on the income statement rather than the balance sheet.

On the other hand, the allowance method based on the balance in the trade receivables accounts attempts to value the accounts receivable at the end of a period at their future collectible amounts. Thus, it focuses on the balance sheet rather than the income statement.

It should be noted, however, that both the allowance method based on credit sales and the allowance method based on the balance in the trade receivables accounts are acceptable under generally accepted accounting principles.

2. Carme Company should report on its balance sheet at December 31, 1981, the balance in the allowance for bad debts account as a valuation or contra asset account; that is, a subtraction from the asset accounts receivable.

Bad debt expense may be presented in the income statement as a selling expense, general and administrative expense, financial expense, or as a subtraction to arrive at net sales.

Answer 3 (10 points)

a. Under the book value method, the carrying value of the convertible bonds at the date of the conversion (the bonds payable less the unamortized discount at that date) would be used to account for the conversion, and there would be no gain or loss recognized on the conversion.

The book value method views the convertible bonds as equity capital, and thus the conversion represents the completion of a prior transaction (the issuance of the convertible debt), not the culmination of an earning process.

Under the market value method, the market value of the common stock at the date of the conversion ($110 per share) would be used to account for the conversion. If the market value of the common stock at the date of the conversion exceeded the carrying value of the convertible bonds at that date, a loss would be recognized on the conversion. If the carrying value of the convertible bonds at the date of the conversion exceeded the market value of the common stock at that date, a gain would be recognized on the conversion.

The market value method views the convertible bonds as debt whose conversion was a significant economic transaction, and thus the conversion represents the culmination of an earning process. Furthermore, the market value method views the market value of the common stock at the date of the conversion to be the proper measurement at which to carry the common stock.

b. The nonconvertible term bonds were sold at a discount because the effective interest rate (yield) of 16 percent was higher than the stated interest rate of 14 percent. Although the bonds provide for the payment of interest of 14 percent, this rate was less than the prevailing or market rate for bonds of similar quality at the time the issue was sold. As a result, the bonds sold on the market at a price less than their par value.

c. The effects associated with the nonconvertible term bonds on Aubrey Company's 1982 income statement are as follows:

- Interest expense for eight months (May 1, 1982, to December 31, 1982) would be included in

Aubrey Company's 1982 income statement. Interest accrues with the passage of time, and the bonds were outstanding for only eight months in 1982.

- Interest expense would be increased for the amortization of bond discount from May 1, 1982 (the date of sale) to December 31, 1982. Amortization of bond discount is justified on the basis of the matching principle. Bond discount should be amortized using the interest method over the period the bond is outstanding, that is, the period from the date of sale to maturity date.

Answer 4 (10 points)

Part a.

1. The direct costing method is useful for internal reporting because it focuses attention on the fixed-variable cost relationship and the contribution margin concept. It facilitates managerial decision-making, product pricing, and cost control. It allows certain calculations to be readily made, such as breakeven points and contribution margins. The focus on the contribution margin (sales revenues less variable costs) enables management to emphasize profitability in making short-run business decisions. Fixed costs are not easily controllable in the short run and hence may not be particularly relevant for short-run business decisions.

2. Assuming that the quantity of ending inventory is higher than the quantity of beginning inventory, operating income using direct costing would be lower than operating income using absorption costing. Direct costing excludes fixed manufacturing overhead from inventories as it considers such costs to be period costs, which are expensed immediately; whereas, absorption costing includes fixed manufacturing overhead in inventories as it considers such costs to be product costs, which are expensed when the goods are sold. When the quantity of inventory increases during a period, direct costing produces a lower dollar increase in inventory than absorption costing. As a result, operating income would be lower.

Part b.

1. Both the net present value method and the internal rate-of-return method have the following advantages over the payback method:

- Consider the time value of money.
- Consider cash flow over the entire life of the project.

2. The limitations of the net present value method are as follows:

- It is more difficult to use than other less sophisticated capital budgeting techniques.
- The discount rate (hurdle rate of return) must be determined in advance.
- Certainty about cash flow is assumed.
- Cash flows are reinvested at the discount rate (hurdle rate of return).

3. The limitations of the internal rate-of-return method are as follows:

- It is more difficult to use than other less sophisticated capital budgeting techniques.
- Cash flows are reinvested at the rate earned by the investment.
- Certainty about cash flow is assumed.

4. Depreciation is excluded from the calculations for both the net present value method and the internal rate-of-return method. Deduction of depreciation would constitute a double-counting of a cost that has already been considered as a lump-sum outflow (the initial cost of the asset). Both the net present value method and the internal rate-of-return method focus on cash flow, while depreciation is an allocation of past cost and is not a cash flow.

Answer 5 (10 points)

a. The change in depreciation method from the double-declining-balance method to the straight-line method constitutes a change in accounting principle and is presented appropriately in David Company's statements of income for the year ended December 31, 1981, and December 31, 1980. The effect of applying the straight-line method for both the year of and the year after the change should be included in cost of goods sold because the periods subsequent to the change should be reported on the basis of the newly adopted accounting principle to assure comparability. The cumulative effect on prior years of the change should not be presented in the continuing operations section of the income statement because it is not part of the continuing operations of David Company.

The loss from operations of the discontinued Dex Division from January 1, 1981, to September 30, 1981 (the portion of the year prior to the measurement date) and from January 1, 1980, to December 31, 1980, should not be presented in the continuing operations section of the income statement. For comparability purposes, each should be presented in the income statement after income from continuing operations as a separate item, less applicable income taxes, because it is not part of the continuing operations of David Company.

David Company's statements of income should be corrected as follows:

- "Other, net" and "total costs and expenses" should be decreased to exclude the loss from operations of the discontinued Dex Division.
- "Income from continuing operations before income taxes" should be increased to exclude the loss from operations of the discontinued Dex Division.
- "Income taxes" should be increased to exclude the tax reduction applicable to the loss from operations of the discontinued Dex Division.
- "Income from continuing operations" should be increased to exclude the loss from operations of the discontinued Dex Division, less applicable income taxes.
- A new caption, "discontinued operations," should be added.
- A new subcaption, "loss from operations of the discontinued Dex Division, less the amount of applicable income taxes," should be added under the caption "discontinued operations."
- The subcaption, "loss on disposal of Dex Division, including provision of $1,500,000 for operating losses during phase-out period, less applicable income taxes of $8,000,000," should be under the caption "discontinued operations."
- "Earnings per share of common stock" should be presented on the face of the income statement for income from continuing operations. As for income from discontinued operations, earnings per share of common stock may be presented on the face of the income statement or in the notes to the financial statements.

b. The price-earnings ratio is of particular interest to investors for evaluating stock price because it relates the earnings of the business to the current market price of the stock. Other internal and external factors besides earnings would also influence the current market price of the stock and hence the price-earnings ratio.

The price-earnings ratio for 1981 is determined by dividing the market value per share by the earnings per share of common stock. The ratio generally would be computed on the basis of the earnings per share of common stock for income from continuing operations.

ACCOUNTING PRACTICE — PART I

May 4, 1983; 1:30 P.M. to 6:00 P.M.

Answer 1 (10 points)

1. d	11. c
2. a	12. a
3. c	13. c
4. c	14. c
5. b	15. c
6. d	16. a
7. d	17. d
8. b	18. a
9. b	19. b
10. b	20. b

Answer 2 (10 points)

21. d	31. b
22. d	32. a
23. c	33. b
24. b	34. b
25. d	35. c
26. d	36. c
27. c	37. b
28. d	38. c
29. a	39. a
30. d	40. d

Answer 3 (10 points)

41. a	51. d
42. c	52. b
43. c	53. b
44. b	54. c
45. d	55. d
46. a	56. d
47. d	57. d
48. a	58. a
49. b	59. a
50. a	60. c

The scores for the multiple choice questions were determined in accordance with the following scales:

Answer 1

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10

Answer 2

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10

Answer 3

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10	10

Answer 4 (10 points)

Part a.

1.

Harris Corporation
ANALYSIS OF CHANGES IN THE ALLOWANCE FOR DOUBTFUL ACCOUNTS
For the Year Ended December 31, 1982

Balance at January 1, 1982	$130,000
Provision for doubtful accounts ($9,000,000 × 2%)	180,000
Recovery in 1982 of bad debts written off previously	15,000
	325,000
Deduct write-offs for 1982 ($90,000 + $60,000)	150,000
Balance at December 31, 1982, before change in accounting estimate	175,000
Increase due to change in accounting estimate during 1982 ($235,300 − $175,000)	60,300
Balance at December 31, 1982, adjusted (Schedule 1)	$235,300

Schedule 1

Computation of Allowance for Doubtful Accounts at December 31, 1982

Aging category	*Balance*	*Percent*	*Doubtful accounts*
November–December 1982	$1,140,000	2	$ 22,800
July–October	600,000	10	60,000
January–June	400,000	25	100,000
Prior to 1/1/82	70,000[a]	75	52,500
			$235,300

[a] $130,000 − $60,000

2.

Harris Corporation
JOURNAL ENTRY
December 31, 1982

Account	*Dr.*	*Cr.*
Provision for doubtful accounts	$60,300	
Allowance for doubtful accounts		$60,300
To increase the allowance for doubtful accounts at December 31, 1982, resulting from a change in accounting estimate.		

Part b.

1.

Lucas Distributors, Inc.

COMPUTATION OF INTERNAL CONVERSION PRICE INDEX FOR INVENTORY POOL NO. 1 DOUBLE EXTENSION METHOD

	December 31, 1981	*December 31, 1982*
Current inventory at current year cost		
Product A	17,000 × \$35 = \$595,000	13,000 × \$40 = \$520,000
Product B	9,000 × \$28 = 252,000	10,000 × \$32 = 320,000
	\$847,000	\$840,000
Current inventory at base cost		
Product A	17,000 × \$30 = \$510,000	13,000 × \$30 = \$390,000
Product B	9,000 × \$25 = 225,000	10,000 × \$25 = 250,000
	\$735,000	\$640,000
Conversion price index	\$847,000 ÷ \$735,000 = 1.15	\$840,000 ÷ \$640,000 = 1.31

2.

Lucas Distributors, Inc.

COMPUTATION OF INVENTORY AMOUNTS UNDER DOLLAR VALUE LIFO METHOD FOR INVENTORY POOL NO. 1

At December 31, 1981 and 1982

	Current inventory at base cost	*Conversion price index*	*Inventory at LIFO cost*
December 31, 1981			
Base inventory	\$560,000	1.00	\$560,000
1981 layer (\$735,000 − \$560,000)	175,000	1.15[a]	201,250
Total	\$735,000[a]		\$761,250
December 31, 1982			
Base inventory	\$560,000	1.00	\$560,000
1981 layer (remaining)	80,000[b]	1.15[a]	92,000
1982 layer	0	1.31[a]	0
Total	\$640,000[a]		\$652,000

[a] See Computation of Internal Conversion Price Index, above.

[b] After liquidation of \$95,000 at base cost:

Product A (4,000 × \$30)	\$120,000
Product B (1,000 × \$25)	(25,000)
Net	\$ 95,000

Answer 5 (10 points)

Bryant Corporation
WORKSHEET FOR BALANCE SHEET AND STATEMENT OF INCOME
November 30, 1982

	Unadjusted balance	*Adjustments Debit*	*Adjustments Credit*	*Adjusted balance*
Balance Sheet				
Assets				
Cash	$ 150,000			$ 150,000
Marketable securities, at cost	60,000			60,000
Allowance for reduction to market			[1] 5,000	(5,000)
Accounts receivable	450,000			450,000
Allowance for doubtful accounts	(59,000)	[2] 23,000		(36,000)
Inventories	430,000	[3] 12,000		442,000
Prepaid insurance	15,000	[4] 3,000		18,000
Property, plant & equipment	426,000	[6] 24,000		450,000
Accumulated depreciation	(40,000)		[6] 2,400	(42,400)
Research & development costs	120,000		[7]120,000	—
	$ 1,552,000			$ 1,486,600
Liabilities & Stockholders' Equity				
Accounts payable & accrued expenses	$ (592,000)		[5] 22,500	(614,500)
Estimated liability from lawsuit			[8] 50,000	(50,000)
Income taxes payable	(224,000)	[9] 55,160		(168,840)
Common stock	(400,000)			(400,000)
Retained earnings	(336,000)	[x] 82,740		(253,260)
	$(1,552,000)			$(1,486,600)
Statement of Income				
Net sales	$(2,950,000)			$(2,950,000)
Cost of sales	1,670,000		[3] 12,000 [6] 24,000	1,634,000
Selling & administrative expenses	650,000	[5] 22,500	[2] 23,000 [4] 3,000	646,500
Depreciation expense	40,000	[6] 2,400		42,400
Research & development expense	30,000	[7]120,000		150,000
Unrealized loss on marketable securities		[1] 5,000		5,000
Estimated loss from lawsuit		[8] 50,000		50,000
Provision for income taxes	224,000		[9] 55,160	168,840
Net income	$ (336,000)	[x] 82,740		$ (253,260)

Bryant Corporation
ADJUSTING JOURNAL ENTRIES
November 30, 1982
(Not required)

	Dr.	*Cr.*
(1)		
Unrealized loss on marketable securities	$5,000	
Allowance to reduce marketable securities to market		$5,000
To reduce short-term investments to market valuation ($60,000 − $55,000)		
(2)		
Allowance for doubtful accounts	23,000	
Selling and administrative expenses (bad debts)		23,000
To reduce allowance account to balance determined by aging of receivables ($59,000 − $36,000)		
(3)		
Inventories	12,000	
Cost of sales		12,000
To adjust for work-in-process inventory held by outside processor		
(4)		
Prepaid insurance	3,000	
Selling and administrative expenses (insurance)		3,000
To adjust for nonrecognition of prepaid expense		
(5)		
Selling and administrative expenses (pension)	22,500	
Accounts payable and accrued expenses		22,500
To accrue normal pension cost (45,000 × 6/12)		
(6)		
Property, plant and equipment	24,000	
Depreciation	2,400	
Cost of sales (repairs & maintenance)		24,000
Accumulated depreciation		2,400
To adjust for charge to repairs and maintenance of machine purchased on 6/1/82, and to record depreciation to 11/30/82 (24,000 × 20% × 6/12)		
(7)		
Research and development expense	120,000	
Research and development costs		120,000
To write off research and development costs in accordance with GAAP		
(8)		
Estimated loss from lawsuit	50,000	
Estimated liability from lawsuit		50,000
To record probable damages payable re: lawsuit for patent infringement		
(9)		
Income taxes payable	55,160	
Provision for income taxes		55,160
To adjust provision for year ended 11/30/82 (Schedule 1)		

Schedule 1

Adjustment to Income Tax Provision—Year Ended November 30, 1982

Unadjusted income before income taxes		$560,000
Add adjustments increasing income		
Reduction in allowance for doubtful accounts	$ 23,000	
Work-in-process inventory at outside processor	12,000	
Recognition of prepaid insurance	3,000	
Reversal of 6/1/82 charge to repairs & maintenance	24,000	62,000
		622,000
Deduct adjustments decreasing income		
Unrealized loss on marketable securities	$ 5,000	
Pension expense	22,500	
Depreciation on machine purchased 6/1/82	2,400	
Research & development expense	120,000	
Estimated loss from lawsuit	50,000	199,900
Adjusted income before income taxes		422,100
Effective income tax rate		×40%
Adjusted provision for income taxes		$168,840
Provision for income taxes per books		$224,000
Adjusted provision for income taxes		168,840
Adjustment to reduce provision [9]		$ 55,160

ACCOUNTING PRACTICE — PART II

May 5, 1983; 1:30 P.M. to 6:00 P.M.

Answer 1 (10 points)

1. c	11. c
2. a	12. c
3. b	13. c
4. d	14. c
5. a	15. d
6. c	16. b
7. b	17. c
8. c	18. a
9. d	19. b
10. b	20. c

Answer 2 (10 points)

21. b	31. c
22. c	32. a
23. d	33. d
24. d	34. d
25. b	35. a
26. b	36. a
27. b	37. b
28. d	38. b
29. d	39. c
30. b	40. d

Answer 3 (10 points)

41. a	51. a
42. d	52. c
43. d	53. a
44. d	54. a
45. c	55. d
46. b	56. b
47. c	57. a
48. b	58. b
49. d	59. c
50. a	60. b

The scores for the multiple choice questions were determined in accordance with the following scales:

Answer 1

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10	10

Answer 2

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10

Answer 3

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10	10	10

Answer 4 (10 points)

a. The breakeven point in patient days equals total fixed costs divided by contribution margin per patient day.

Pediatrics
COMPUTATION OF BREAKEVEN POINT IN PATIENT DAYS
For the Year Ending June 30, 1983

Total fixed costs (Schedule 1)	$3,380,000
Divided by contribution margin per patient day (Schedule 2)	$ 200
Breakeven point in patient days	16,900

Schedule 1

Total Fixed Costs

Melford Hospital charges		$2,900,000
Supervising nurses	($25,000 × 4)	100,000
Nurses	($20,000 × 10)	200,000
Aides	($ 9,000 × 20)	180,000
Total fixed costs		$3,380,000

Schedule 2

Contribution Margin Per Patient Day

Revenue per patient day	$300
Variable costs per patient day	
($6,000,000 ÷ $300 = 20,000 patient days)	
($2,000,000 ÷ 20,000 patient days)	100
Contribution margin per patient day	$200

b.

Pediatrics
COMPUTATION OF LOSS FROM RENTAL OF ADDITIONAL 20 BEDS
For the Year Ending June 30, 1983

Increase in revenue (20 additional beds × 90 days × $300 charge per day)	$ 540,000
Increase in expenses	
Variable charges by Melford Hospital (20 additional beds × 90 days × $100 per day)	180,000
Fixed charges by Melford Hospital ($2,900,000 ÷ 60 beds = $48,333 per bed × 20 beds) or [$2,900,000 × (20 ÷ 60)]	966,667
Salaries expense (20,000 patient days before additional 20 beds, + 20 additional beds × 90 days = 21,800, which does not exceed 21,900 patient days; therefore, no additional personnel are required)	—
Total increase in expenses	1,146,667
Net decrease in earnings from rental of additional 20 beds	$ 606,667

Answer 5 (10 points)

a.

Community Sports Club
TRANSACTIONS
For the Year Ended March 31, 1983

		Dr.	*Cr.*
(1)	Cash	$20,000	
	Revenue — annual dues		$20,000
(2)	Cash	28,000	
	Revenue — snack bar and soda fountain		28,000
(3)	Cash	6,000	
	Investment income		6,000
(4)	Expense — house	17,000	
	Expense — snack bar and soda fountain	26,000	
	Expense — general and administrative	11,000	
	Accounts payable		54,000
(5)	Accounts payable	55,000	
	Cash		55,000
(6)	Assessments receivable	10,000	
	Deferred capital support		10,000
(7)	Cash	5,000	
	Revenue — bequest (unrestricted revenue)		5,000

ADJUSTMENTS
March 31, 1983

(1)	Investments	7,000	
	Unrealized gain on investments		7,000
(2), (3)	Expense — house	9,000	
	Expense — snack bar and soda fountain	2,000	
	Expense — general and administrative	1,000	
	Accumulated depreciation - building		4,000
	Accumulated depreciation - furniture and equipment		8,000
(4)	Expense — snack bar and soda fountain	4,000	
	Inventories		4,000

b.

Community Sports Club
STATEMENT OF REVENUE, EXPENSES, AND CHANGES IN CUMULATIVE EXCESS OF REVENUE OVER EXPENSES
For the Year Ended March 31, 1983

Revenue		
Snack bar and soda fountain sales		$28,000
Dues		20,000
Investment income		6,000
Bequest		5,000
Total revenue		59,000
Expenses		
Snack bar and soda fountain	$32,000	
House	26,000	
General and Administrative	12,000	
Total expenses		70,000
Deficiency of revenue over expenses before unrealized gain on investments		(11,000)
Unrealized gain on investments		7,000
Deficiency of revenue over expenses after unrealized gain on investments		(4,000)
Cumulative excess of revenue over expenses at April 1, 1982		12,000
Cumulative excess of revenue over expenses at March 31, 1983		$ 8,000

AUDITING

May 5, 1983; 8:30 A.M. to 12:00 M.

Answer 1 (60 points)

1. b	11. c	21. d	31. a	41. b	51. b
2. b	12. b	22. c	32. c	42. c	52. d
3. d	13. c	23. d	33. b	43. a	53. d
4. c	14. b	24. b	34. d	44. d	54. d
5. a	15. b	25. d	35. c	45. b	55. b
6. a	16. a	26. a	36. b	46. b	56. c
7. b	17. b	27. a	37. b	47. b	57. a
8. a	18. b	28. b	38. c	48. b	58. c
9. d	19. c	29. a	39. d	49. d	59. a
10. a	20. b	30. b	40. a	50. c	60. a

The score for the multiple choice question was determined in accordance with the following scale:

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20

Correct	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40
Score	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40

Correct	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60
Score	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60

Answer 2 (10 points)

Other matters that Alderman's representation letter should specifically confirm include whether or not—

- Management acknowledges responsibility for the fair presentation in the financial statements of financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles (or other comprehensive basis of accounting).
- All material transactions have been properly reflected in the financial statements.
- There are other material liabilities or gain or loss contingencies that are required to be accrued or disclosed.
- The company has satisfactory title to all owned assets, and whether there are liens or encumbrances on such assets or any pledging of assets.
- There are related party transactions or related amounts receivable or payable that have not been properly disclosed in the financial statements.
- The company has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
- Events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements.
- The accountant has been advised of all actions taken at meetings of stockholders, board of directors, and committees of the board of directors (or other similar bodies) that may affect the financial statements.
- All financial records and data were made available.
- Management is aware of irregularities that could have a material effect on the financial statements or that involve management or employees who have significant roles in the system of internal control.
- Provision, when material, has been made to reduce excess or obsolete inventories to their estimated net realizable value.
- Provision has been made for any material loss to be sustained in the fulfillment of, or from inability to fulfill, any sales commitments.
- Provision has been made for any material loss to be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of the prevailing market prices.

Answer 3 (10 points)

Deficiencies in the auditor's report, as drafted by the audit assistant, may be categorized as follows:

- The scope paragraph did not specifically identify the financial statements that were examined or the period of time they covered. Further, the scope paragraph did not specifically state that the examination included tests of accounting records, and it did not refer the reader to the second middle paragraph.
- The second middle paragraph, which should have been explanatory, improperly disclaimed an opinion on the financial statements taken as a whole.
- The opinion paragraph did not express an opinion on the results of operations and changes in financial position for the period, and the period covered by these financial statements was not identified. Further, it did not state that the balance sheet was presented fairly in conformity with generally accepted accounting principles, and it did not refer to the consistent application of generally accepted accounting principles.

  If the intent was to express a qualified opinion, the reason for the qualification should have been referred to in both the scope and opinion paragraphs and the wording in the opinion paragraph should have indicated that the qualification pertained to the possible effects on the financial statements and not the scope limitation itself. Further, the "subject to" phrase should not have been used.
- The report should have been addressed to the Board of Directors; Stockholders; or Corporation.
- The date of the report should have been as of the last date of the field work.

Answer 4 (10 points)

Basic audit procedures that should be performed by Kautz in gathering evidence in support of each of the items **(a)** through **(f)** are as follows:

Balance per bank (item a)

- Confirm by direct written communication with bank.
- Obtain and inspect a January-1983-cutoff bank statement directly from the bank (examine opening balance).

Deposit in transit (item b)
- Verify that the deposit was listed in the January-1983-cutoff bank statement on a timely basis.
- Trace to the cash receipts journal.
- Inspect the client's copy of the deposit slip for the date of deposit.

Outstanding checks (item c)
- Trace to the cash disbursements journal.
- Examine all supporting documents for those outstanding checks that were not returned with the cutoff bank statement.
- Examine checks accompanying the January-1983-cutoff bank statement and trace all 1982, or prior, checks to the outstanding check list.
- Ascertain why check number 837 is still outstanding, if possible.

NSF check returned (item d)
- Follow up on the ultimate disposition of the NSF check.
- Examine all supporting documents.

Note collected (item e)
- Examine bank credit memo.

Balance per books (item f)
- Foot this total and compare this balance with the general ledger balance.

Answer 5 (10 points)

A. Prepare purchase order
B. To vendor
C. Prepare receiving report
D. From purchasing
E. From receiving
F. Purchase order no. 5
G. Receiving report no. 1
H. Prepare and approve voucher
I. Unpaid voucher file, filed by due date
J. Treasurer
K. Sign checks and cancel voucher package documents
L. Cancelled voucher package

BUSINESS LAW
(Commercial Law)
May 6, 1983; 8:30 A.M. to 12:00 M.

Answer 1 (60 points)

1. a	11. a	21. d	31. a	41. d	51. b
2. d	12. d	22. d	32. a	42. c	52. d
3. c	13. d	23. c	33. b	43. b	53. d
4. b	14. c	24. d	34. c	44. d	54. b
5. a	15. c	25. c	35. a	45. b	55. d
6. b	16. b	26. c	36. c	46. a	56. d
7. c	17. d	27. a	37. b	47. c	57. a
8. d	18. a	28. d	38. a	48. a	58. c
9. d	19. d	29. d	39. a	49. b	59. c
10. b	20. b	30. b	40. b	50. b	60. a

The score for the multiple choice question was determined in accordance with the following scale:

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29

Correct	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40
Score	30	31	32	33	34	35	36	37	38	39	40	41	42	43	44	45	46	47	48	49

Correct	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60
Score	50	51	52	53	54	55	56	57	58	59	60	60	60	60	60	60	60	60	60	60

Answer 2 (10 points)

Part a.

1. No. Peters will not prevail. The facts do not involve liability in the sale of registered securities nor liability for reports filed with the SEC. Because the stock transaction involved interstate commerce, Peters's claim may be based on section 17 (the antifraud provision) of the Securities Act of 1933 and rule 10b-5 under the Securities Exchange Act of 1934. In either case, he will have to show fraud on the part of Doe, or a manipulative device or scheme, in connection with the sale of a security under the 1933 act or the purchase or sale of a security under the 1934 act. If this can be shown, an implied civil damage remedy is available to Peters against Doe.

Although Doe was negligent, the United States Supreme Court, in the *Hochfelder* case, held that a violation of rule 10b-5 requires scienter, something greater than mere negligence. Unless the violation of GAAS involves intent, or gross negligence, Doe would not be held in violation of rule 10b-5.

Similarly, Peters might claim a remedy against Doe for violation of section 17 of the 1933 Securities Act. The Supreme Court, in the *Aaron* case, held no scienter is required in certain section 17 cases brought by the SEC, but it appears that private actions, such as the one by Peters, would be subject to provisions similar to those in rule 10b-5.

2. No. Peters will not prevail based upon his state common law action either. At common law, privity is required before an accountant can be held liable to users of the financial statements, absent fraud. Doe was not in privity of contract with Peters, nor does the question indicate that Doe was even aware that Peters would rely on the financial statements.

Part b.

Yes. Ira will prevail and recover damages from Baker. He will base his action on section 11 of the Securities Act of 1933. Section 11 imposes liability on experts, including accountants, whose opinions appear in a registration statement. The experts are liable to all those who in reliance on their opinions purchase securities in a public offering under the 1933 act. Ira does not have to prove Baker was negligent in auditing Able. All he need allege and prove is that there is a material false statement or omission of a material fact in the registration statement. The only defense that Baker may assert is that it exercised the degree of care that would be exercised by certified public accountants in similar circumstances. This is commonly referred to as the "due diligence" defense. Negligence by Baker is therefore a violation of section 11, and makes Baker liable to Ira for his damages.

Answer 3 (10 points)

Part a.

1. Since Higgins has two different discount structures, there is a prima facie price discrimination case. In order to prevail in such a case the seller may affirmatively prove cost justification as a defense as provided in the Robinson-Patman Act. Although, in general, quantity discounts may be granted based on amounts purchased, a manufacturer must grant these discounts on the basis of reasonably drawn classes. The company need not prove actual cost savings resulting from purchases made by each member of the class. However, the costs of the sales to the buyers must be of sufficient homogeneity. This means that the costs incurred in selling to members of a particular class must be very similar, i.e., there must be a rational and persuasive basis for the determination of the class. Higgins has established two classes, chain stores and independent grocers. In order for Higgins to establish the cost reductions, it might look to manufacturing, sales, delivery, collection, and accounting costs. The defense of cost justification requires precise accounting data and historically has not met with much success in the courts.

2. One of the elements set forth in this action is that the sales relate to commodities of "like grade and quality." The test here is that the commodities affected must either be physically identical or so physically similar that the commercial value of the commodities is not significantly different. Thus, the phrase "like grade and quality" relates exclusively to the physical characteristics of the commodity. In this case, the fact that some of the sales were under Higgins's brand name and some under a "private label" would not affect the outcome.

Part b.

West will prevail. The failure to include information concerning the unfavorable contracts is a violation of section 14(a) of the Securities Exchange Act of 1934, which applies to the proxy material of companies whose securities are traded on a national securities exchange.

A violation of section 14 gives rise to an implied right of action by aggrieved shareholders if the omitted or erroneous information is "material." The Supreme Court has defined the word material as meaning "likely to affect the vote of a shareholder on the proposed action." Here, the information is clearly material to the vote of the Jones shareholders.

The possible remedy for violation of section 14 is within the court's discretion and includes damages or injunctive relief. In the case of a merger that has not been consummated, a court would likely set aside the vote and require resolicitation of the proxy material.

Answer 4 (10 points)

The action to compel reinstatement of prior dividends would fail. The declaration of dividends is a matter within the discretion of the board of directors. There are very few instances in which the board's discretion will be disturbed, and the facts of this problem are not within any of them unless Cox can prove the fraudulent purpose of the board, which she asserts.

The predominant rule gives a corporation the right to acquire its own shares. Such purchases may be made only to the extent of unreserved and unrestricted earned surplus. Capital surplus may be used only if the articles of incorporation so provide or if there is an affirmative majority vote by shareholders. The law and the facts indicate that in all probability there was no problem from the standpoint of the proper source of funds. With respect to the sale below par value there is no requirement to sell treasury shares at par value. The corporation laws require only that newly issued shares be sold at or above par value.

Cox's action to demand repayment of the salary increases would fail. The board of directors has broad discretionary power to fix salaries of officers, even if the officers also are members of the board. The courts have supported the board's determination of salary unless the amounts are grossly unreasonable. A 10 percent per year raise and the fact that the salaries are within the upper one-third of those paid by other similar corporations do not suggest salaries that would likely be found unreasonable and a waste of corporate assets.

Cox's action for dissolution would fail. The courts have power to dissolve a corporation in an action by a shareholder when the directors are deadlocked in the management of the corporate affairs and the shareholders are unable to break the deadlock. To obtain a court-ordered dissolution Cox must also prove that irreparable injury to the corporation is being suffered or is threatened. None of these facts are present. The fact that there is bitterness and animosity does not constitute a deadlock of the management. The corporation is continuing to increase its earnings at a 10 percent per year rate. Courts are loath to grant an order for an involuntary dissolution even if there is a serious deadlock, provided the corporation continues to be a viable economic entity.

Answer 5 (10 points)

Part a.

1. Pine is not a holder in due course because he has knowledge of a defense against the note. However, Pine has the rights of a holder in due course because he acquired the note through Gordon, who was a holder in due course. The rule wherein a transferee, not a holder in due course, acquires the rights of one by taking from a holder in due course is known as the "shelter rule." Through these rights, Pine is entitled to recover the proceeds of the note from Beeler. The defense of fraud in the inducement is a personal defense and not valid against a holder in due course or one with the rights of a holder in due course.

2. As one with the rights of a holder in due course, Pine is entitled to proceed against any person whose signature appears on the note, provided he gives notice of dishonor. When Dunhill negotiated the note to Gordon, Dunhill's signature on the note made him secondarily liable. As a result, if Pine brings suit against Dunhill, Pine would prevail because of Dunhill's secondary liability.

Part b.

1. Although the parties involved are permitted to allocate risk of loss in any manner they deem appropriate, assuming that there was no provision in the agreement regarding risk of loss, the Uniform Commercial Code sets forth very specific rules which depart sharply from the common law concept dependent upon whether title had been transferred. Sales contracts that require the seller to ship the goods F.O.B. seller's location are known as "shipment" contracts, while contracts requiring the seller to deliver to a particular destination are known as "destination" contracts.

The first set of tools was sold under "destination" terms which means that risk of loss passed to Dennison only when the goods arrived at that destination and were duly tendered to enable Dennison to take delivery. Thus, Elba would bear the risk of loss.

Regarding the second set, which entailed "shipment" terms, risk of loss passed when the goods were properly delivered to the carrier. Thus, although the property was destroyed prior to delivery, risk of loss had already passed to Dennison.

2. Drew. The UCC sets forth specific provisions regarding the effects of breach (both by the seller and buyer) on risk of loss. Assuming a seller's breach, as is the case here, the code provides that where a tender or delivery of goods so fails to conform to the contract as to give a right of rejection, the risk of loss remains on the seller until cure or acceptance.

ACCOUNTING THEORY
(Theory of Accounts)
May 6, 1983; 1:30 P.M. to 5:00 P.M.

Answer 1 (60 points)

1. d	11. d	21. b	31. c	41. d	51. c
2. a	12. c	22. b	32. c	42. b	52. d
3. b	13. a	23. a	33. b	43. d	53. b
4. b	14. d	24. b	34. a	44. d	54. a
5. b	15. b	25. c	35. b	45. c	55. b
6. b	16. d	26. b	36. c	46. c	56. b
7. d	17. a	27. c	37. c	47. b	57. a
8. b	18. c	28. d	38. a	48. d	58. a
9. b	19. d	29. c	39. d	49. b	59. a
10. c	20. c	30. a	40. d	50. b	60. c

The score for the multiple choice question was determined in accordance with the following scale:

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25

Correct	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40
Score	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40	41	42	43	44	45

Correct	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60
Score	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60	60	60	60	60	60

Answer 2 (10 points)

a.

1. Cash discounts should not be accounted for as financial income when payments are made. Income should be recognized when the earning process is complete (when Taylor sells the inventory). Furthermore, cash discounts should not be recorded when the payments are made because in order to properly match a cash discount with the related purchase, the cash discount should be recorded when the related purchase is recorded.

2. Cash discounts should not be accounted for as a reduction of cost of goods sold for period when payments are made. Cost of goods sold should be reduced when the earning process is complete (when Taylor sells the inventory which has been reduced by the cash discounts). Furthermore, cash discounts should not be recorded when the payments are made because in order to properly match a cash discount with the related purchase, the cash discount should be recorded when the related purchase is recorded.

3. Cash discounts should be accounted for as a direct reduction of purchase cost because they reduce the cost of the inventories. Purchases should be recorded net of cash discount to reflect the net cash to be paid. The primary basis of accounting for inventories is cost, which represents the price paid or consideration given to acquire an asset.

b. Inventories would be lower using the LIFO inventory method instead of the FIFO method over a substantial time period when purchase prices of household appliances are rising because the inventories are at the oldest (lower) purchase prices instead of the most recent (higher) purchase prices. Correspondingly, cost of goods sold would be higher because the cost of goods sold is at more recent (higher) purchase prices instead of older (lower) purchase prices. Consequently, net income and retained earnings would be lower.

More cash flow would generally be available using the LIFO inventory method instead of the FIFO method because taxable income is decreased, resulting generally in accrual and payment of lower income taxes. Correspondingly, income tax expense would generally be lower.

c. The lower of cost-or-market rule is used for valuing inventories when the FIFO method is used because of (a) the matching principle, that is, the decline in the utility of the household appliances inventories below its cost should be recognized as a loss in the current period, and (b) the concept of balance sheet conservatism.

Answer 3 (10 points)

a. The adjustment for an extraordinary item of \$14 million should not be presented as a prior period adjustment in the Lynch Company Statement of Retained Earnings. The extraordinary item should be included in net income and presented in the income statement as a separate item, net of income taxes because net income should reflect all items of profit and loss recognized during the period. Furthermore, the amount of income taxes netted to arrive at the \$14 million should be presented in the income statement.

The adjustment for correction of error in the financial statements of prior periods of \$11 million in 1981 should not be presented in the portion of the Lynch Company Statement of Retained Earnings with the activity during the year. A correction of an error should be reported as a prior period adjustment. It should be presented in the Lynch Company Statement of Retained Earnings as "adjustment for correction of error" between "retained earnings at beginning of period, as previously reported" and "retained earnings at beginning of period, as restated." Furthermore, the amount of income taxes netted to arrive at the \$11 million should be presented in the Lynch Company Statement of Retained Earnings.

The 10 percent stock dividend of \$20 million is presented appropriately in the Lynch Company Statement of Retained Earnings. In accounting for a small stock dividend, retained earnings is debited for the market value of the stock at the date of the stock dividend, common stock is credited for the par value of the stock, and the difference is credited to additional paid-in capital. Total stockholders' equity does not change; but recognition has been made of a capitalization of retained earnings equivalent to the fair value of the additional shares resulting from the stock dividend.

The treasury stock of \$6 million should not be presented in the Lynch Company Statement of Retained Earnings. Under the cost method of accounting for treasury stock transactions, the cost of the stock (market value on the date of the purchase) should be debited to treasury stock and presented as a separate item in the Lynch Company Statement of Stockholders' Equity because it is an unallocated reduction of stockholders' equity.

b. The additional facts above concerning the stock dividend and treasury stock transaction affected the cash dividend per share (pay-out) ratio because the earnings per share of common stock was affected as follows:

- The 10 percent stock dividend decreased the earnings per share because there were more shares outstanding after the 10 percent stock dividend;

thus the cash dividend per share (pay-out) ratio was increased.

- The treasury stock transaction increased the earnings per share because there were less shares outstanding after the treasury stock transaction (treasury stock is not part of outstanding common stock and no dividends are paid out on treasury stock); thus the cash dividend per share (pay-out) ratio was decreased.

Answer 4 (10 points)

Part a.

1. The weighted-average method of process costing combines beginning work in process inventory costs with costs of the new period by adding the cost of the work in process inventory at the beginning of the period to the costs of the new period.

2. The weighted-average method of process costing would be inappropriate when beginning and ending inventories change radically from month to month and conversion costs per unit change radically from month to month.

3. The weighted-average method of process costing is generally easier to use than the first-in, first-out method primarily because the beginning work in process inventory is averaged in as part of current production. Furthermore, if several unit cost figures are used at the same time, extensive detail is required in the first-in, first-out method which can lead to complex procedures and even inaccuracy; and under such conditions the weighted-average method leads to more satisfactory cost computations.

The weighted-average method of process costing averages out uneven but expected cost incurrences over the entire period. This will reduce the fluctuations in unit costs and reflect operating experience for the period as a whole.

4. The units of the work in process inventory at the end of the period would be multiplied by one quarter (the portion complete as to conversion costs). The result would then be multiplied by the conversion cost per equivalent unit to arrive at the conversion cost portion of the ending work in process inventory.

Part b.

1. Daly would determine the number of units of Product Y that it would have to sell to attain a 20 percent profit on sales by dividing total fixed costs plus desired profit (20 percent of the sales price per unit multiplied by the units to attain a 20 percent profit) by unit contribution margin (sales price per unit less variable cost per unit).

2. If variable cost per unit increases as a percentage of the sales price, Daly would have to sell more units of Product Y to break even. Because the unit contribution margin (sales price per unit less variable cost per unit) would be lower, Daly would have to sell more units to cover the fixed costs.

3. The limitations of breakeven analysis in managerial decision-making are as follows:

- The breakeven chart is fundamentally a static analysis, and, in most cases, changes can only be shown by drawing a new chart or series of charts.
- The amount of fixed and variable cost, as well as the slope of the sales line, is meaningful in a defined range of activity and must be redefined for activity outside the relevant range.
- It is difficult to determine the fixed and variable components of cost.
- It is assumed that product mix will be unchanged.
- It is assumed that product technology will be unchanged.
- It is assumed that labor productivity will be unchanged.
- It is assumed that selling prices and other market conditions will be unchanged.

Answer 5 (10 points)

Part a.

For Type A merchandise, the estimated product warranty costs should be accrued by a charge to income and a credit to a liability because both of the following conditions were met:

1. It is probable that a liability has been incurred based on past experience. Thus, the matching principle is being followed.
2. The amount of loss can be reasonably estimated as 1 percent of sales.

For Type B merchandise, the estimated product warranty costs should not be accrued by a charge to income because the amount of loss cannot be reasonably estimated.

Part b.

The probable judgment ($400,000) should be accrued by a charge to income and a credit to a liability because both of the following conditions were met:

1. It is probable that a liability has been incurred

because Carpenter's lawyer states that it is probable that Carpenter will lose the suit.

2. The amount of loss can be reasonably estimated because Carpenter's lawyer states that the most probable judgment is $400,000.

Thus, the principle of conservatism is being followed.

Carpenter should disclose the following in its financial statements or notes:

- The amount of the suit ($2 million)
- The nature of the accrual
- The nature of the contingency
- The range of loss ($200,000 to $900,000)

ACCOUNTING PRACTICE — PART I

November 2, 1983; 1:30 to 6:00 P.M.

Answer 1 (10 points)

1. b
2. a
3. b
4. d
5. d
6. b
7. c
8. b
9. d
10. c
11. d
12. a
13. a
14. d
15. c
16. a
17. d
18. a
19. c
20. c

Answer 2 (10 points)

21. b
22. a
23. c
24. c
25. d
26. c
27. c
28. b
29. b
30. a
31. a
32. b
33. d
34. d
35. b
36. a
37. a
38. c
39. d
40. a

Answer 3 (10 points)

41. d
42. a
43. a
44. d
45. b
46. c
47. a
48. c
49. d
50. b
51. d
52. b
53. c
54. a
55. d
56. b
57. c
58. c
59. b
60. b

The scores for the multiple choice questions were determined in accordance with the following scales:

Answer 1

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10	10	10

Answer 2

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10	10

Answer 3

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10	10

Answer 4 (10 points)

1.

Ashwood, Inc.
STATEMENT OF RETAINED EARNINGS
For the Year Ended December 31, 1982

Balance, December 31, 1981, as originally reported		$ 6,500,000
Add prior period adjustment from error understating inventories at December 31, 1981	$ 300,000	
Less income tax effect	120,000	180,000
As restated		6,680,000
Net income		4,500,000
		11,180,000
Deduct cash dividends		
On preferred stock at required rate		
[$4.50 ($50 × 9%) × 100,000 shares]	450,000	
On common stock, $1.00 per share		
[$1 × 2,480,000 shares (2,000,000 + 500,000 − 20,000)]	2,480,000	2,930,000
Balance, December 31, 1982		$ 8,250,000

2.

Ashwood, Inc.
STOCKHOLDERS' EQUITY SECTION OF BALANCE SHEET
December 31, 1982

Preferred stock, $50 par value, 9% cumulative, convertible; 600,000 shares authorized; 100,000 shares issued and outstanding	$ 5,000,000
Common stock, $10 par value; 6,000,000 shares authorized; 2,500,000 shares issued (2,000,000 + 500,000), of which 10,000 shares are held in treasury	25,000,000
Additional paid-in capital from preferred stock [100,000 × $4 ($54 − $50)]	400,000
Additional paid-in capital from common stock (Schedule 1)	11,050,000
Retained earnings	8,250,000
	49,700,000
Less common stock in treasury, 10,000 shares at cost [$16 × 10,000 (20,000 − 10,000)]	160,000
Total stockholders' equity	$49,540,000

Schedule 1

Additional Paid-In Capital From Common Stock

Balance, December 31, 1981	$ 7,500,000
From issuance of 500,000 shares on April 30, 1982 [500,000 × $7 ($17 − $10)]	3,500,000
From sale of 10,000 shares treasury stock on November 10, 1982 [10,000 × $5 ($21 − $16)]	50,000
Balance, December 31, 1982	$11,050,000

3.

Ashwood, Inc.
COMPUTATION OF BOOK VALUE PER SHARE OF COMMON STOCK
December 31, 1982

Total stockholders' equity	$49,540,000
Deduct allocation to preferred stock	
Preferred stock at liquidation value (100,000 shares × $50)	5,000,000
Allocation to common stock [2,490,000 shares outstanding (2,500,000 − 10,000)]	$44,540,000
Book value per share of common stock ($44,540,000 ÷ 2,490,000)	$ 17.89

Answer 5 (10 points)

Amboy Corporation and Subsidiary
CONSOLIDATING STATEMENT WORKSHEET
December 31, 1982

Income Statement	*Amboy Corp.*	*Taft Inc.*	*Adjustments & Eliminations** *Debit*	*Credit*	*Adjusted Balance*
Net sales	$(1,900,000)	$(1,500,000)	[6] 180,000		$(3,220,000)
Dividends from Taft	(40,000)		[3] 40,000		—
Gain on sale of warehouse	(30,000)		[4] 30,000		—
Cost of goods sold	1,180,000	870,000		[6] 162,000	1,888,000
Operating expenses (incl. deprec.)	550,000	440,000	[2] 12,000	[5] 2,000	1,000,000
Net income	$ (240,000)	$ (190,000)	[a] 262,000	[a] 164,000	$ (332,000)
Retained Earnings Statement					
Balance, 1/1/82	$ (220,000)	$ (156,000)	[1] 156,000		$ (220,000)
Net income	(240,000)	(190,000)	[a] 262,000	[a] 164,000	(332,000)
Dividends paid		40,000		[3] 40,000	—
Balance, 12/31/82	$ (460,000)	$ (306,000)	[b] 418,000	[b] 204,000	$ (552,000)
Balance Sheet					
Assets					
Cash	$ 285,000	$ 150,000			$ 435,000
Accounts receivable (net)	430,000	350,000		[7] 75,000	705,000
Inventories	530,000	410,000		[6] 18,000	922,000
Land, plant & equipment	660,000	680,000	[1] 54,000	[4] 30,000	1,364,000
Accumulated depreciation	(185,000)	(210,000)	[5] 2,000	[2] 9,000	(402,000)
Investment in Taft (at cost)	750,000			[1] 750,000	—
Goodwill			[1] 60,000	[2] 3,000	57,000
	$ 2,470,000	$ 1,380,000			$3,081,000
Liabilities & Stockholders' Equity					
Accounts pay. & accrued exp.	$ (670,000)	$ (594,000)	[7] 75,000		$(1,189,000)
Common stock ($10 par)	(1,200,000)	(400,000)	[1] 400,000		(1,200,000)
Additional paid-in capital	(140,000)	(80,000)	[1] 80,000		(140,000)
Retained Earnings	(460,000)	(306,000)	[b] 418,000	[b] 204,000	(552,000)
	$(2,470,000)	$(1,380,000)	1,089,000	1,089,000	$(3,081,000)

*Explanations of Adjustments & Eliminations

[1] To eliminate the reciprocal elements in investment, equity, and property accounts. Amboy's investment is carried at cost at December 31, 1982.

[2] To record amortization of current value in excess of book value of Taft's machinery at date of acquisition ($54,000 ÷ 6) and amortization of goodwill ($60,000 ÷ 20) for the year ended December 31, 1982.

[3] To eliminate Amboy's dividend income from Taft.

[4] To eliminate the intercompany profit on the sale of the warehouse by Amboy to Taft.

[5] To eliminate the excess depreciation on the warehouse building sold by Amboy to Taft [($86,000 − $66,000) ÷ 5] × ½.

[6] To eliminate intercompany sales from Taft to Amboy and the intercompany profit in Amboy's ending inventory as follows.

	Total	*On hand*
Sales	$180,000	$36,000
Gross profit	90,000	18,000

[7] To eliminate Amboy's intercompany balance for merchandise owed to Taft.

ACCOUNTING PRACTICE — PART II

November 3, 1983; 1:30 to 6:00 P.M.

Answer 1 (10 points)

1. d	11. c
2. b	12. d
3. d	13. a
4. c	14. c
5. b	15. d
6. b	16. b
7. c	17. b
8. d	18. c
9. a	19. b
10. a	20. a

Answer 2 (10 points)

21. a	31. c
22. c	32. b
23. c	33. b
24. b	34. b
25. d	35. c
26. b	36. d
27. c	37. a
28. a	38. c
29. c	39. d
30. a	40. c

Answer 3 (10 points)

41. a	51. a
42. b	52. d
43. c	53. a
44. d	54. c
45. a	55. a
46. a	56. b
47. d	57. d
48. a	58. d
49. b	59. b
50. d	60. c

The scores for the multiple choice questions were determined in accordance with the following scales:

Answer 1

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10

Answer 2

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10	10	10

Answer 3

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10

Answer 4 (10 points)

a.

Rapapo State University
SUMMARY JOURNAL ENTRIES
For the Year Ended July 31, 1983

		Current Funds			
		Unrestricted		*Restricted*	
Entry no.	*Accounts*	*Debit*	*Credit*	*Debit*	*Credit*
1.	Cash	$3,000,000			
	Accounts receivable—tuition and fees		$ 362,000		
	Revenue—tuition and fees		2,500,000		
	Deferred revenue—tuition and fees		138,000		
2.	Deferred revenue—tuition and fees	25,000			
	Revenue—tuition and fees		25,000		
3.	Allowance for doubtful accounts	13,000			
	Accounts receivable—tuition and fees		13,000		
	Provision for uncollectible tuition and fees	8,000			
	Allowance for doubtful accounts		8,000		
4.	State appropriation receivable	60,000			
	Revenue—state appropriation		60,000		
5.	Cash	80,000			
	Revenue—gifts		80,000		
	Fund balance	30,000			
	Cash		30,000		
6.	Cash			$31,000	
	Investments				$25,000
	Fund balance				6,000
	Investments			40,000	
	Cash				40,000
	Cash			18,000	
	Fund balance				18,000
7.	Expenditures—general expenses	2,500,000			
	Accounts payable		2,500,000		
	Accounts payable	2,525,000			
	Cash		2,525,000		
8.	Accounts payable			5,000	
	Cash				5,000
9.	Due to other funds	40,000			
	Cash		40,000		
10.	Expenditures—general expenses	10,000			
	Prepaid expenses		10,000		

Answer 4 (continued)

b.

Rapapo State University
STATEMENT OF CHANGES IN FUND BALANCES
For the Year Ended July 31, 1983

	Current Funds: *Unrestricted*	Current Funds: *Restricted*
Revenues and other additions		
Tuition and fees	$2,525,000	
State appropriation	60,000	
Gifts	80,000	
Gain on sale of investments		$ 6,000
Investment income		18,000
Total revenues and other additions	2,665,000	24,000
Expenditures and other deductions		
Educational and general	2,518,000	
Transfer among funds (deduction)		
Allocation to loan fund	(30,000)	
Net increase for the year	117,000	24,000
Fund balance at beginning of year	435,000	215,000
Fund balance at end of year	$ 552,000	$239,000

Answer 5 (10 points)

a.

Winsor Company
SCHEDULE OF CURRENT MARKETABLE EQUITY SECURITIES
December 31, 1983

	Number of shares	*Cost*	*Market price per share*	*Market value*	*Unrealized gross gain or (loss)*
Bea—preferred	500	$ 20,000	$56	$ 28,000	$ 8,000
Bea—common	1,500	20,000	20	30,000	10,000
Cha—common	3,500	35,000	11	38,500	3,500
Dey—common	1,700	42,500	22	37,400	(5,100)
		$117,500		$133,900	$16,400
Valuation allowance		-0-			
Carried at cost		$117,500			

The valuation allowance of $7,000 at December 31, 1982, for current marketable equity securities should be eliminated by a debit to valuation allowance—current, and a credit to unrealized gain on current marketable equity securities. This $7,000 unrealized gain should be included in Winsor's income statement for the year ended December 31, 1983.

Answer 5 (continued)

b.

Winsor Company
SCHEDULE OF NONCURRENT MARKETABLE EQUITY SECURITIES
December 31, 1983

Eddie Corp.—100,000 shares of common stock:		
Cost		
In underlying equity		$1,400,000
In excess of underlying equity	$300,000	
Less amortization of excess of cost over underlying equity	(7,500)	292,500
Net cost		1,692,500
Increase in equity during 1983		
Equity in Eddie's earnings		360,000
Less dividends received		(200,000)
Carrying amount of Eddie Corp. investment		$1,852,500

c.

Winsor Company
SCHEDULE OF INVESTMENT INCOME
For the year ended December 31, 1983

Dividends	
Bea Corp.—preferred (1,000 shares × $2.40 per share)	$ 2,400
Cha, Inc.—common (3,500 shares × $1.00 per share)	3,500
Total dividend income	$ 5,900
Realized gain (loss) on sale of securities	
Cha, Inc.—common ($13 − $10 = $3 × 2,500 shares)	$ 7,500
Dey Co.—common ($55,000/(2,000 shares × 110%), or cost per share of $25 − $21 selling price per share = $4 loss per share × 500 shares sold)	(2,000)
Net realized gain on sale of securities	$ 5,500
Unrealized gain on current marketable equity securities (see Required **a.**)	$ 7,000
Equity in income of Eddie Corp.	
Winsor's 30% interest in Eddie's net income of $1,200,000	$360,000
Amortization of excess of cost over underlying equity	(7,500)
Equity in income of Eddie Corp.	$352,500

AUDITING

November 3, 1983; 8:30 A.M. to 12:00 M.

Answer 1 (60 points)

1. d	11. d	21. d	31. b	41. b	51. d
2. c	12. a	22. a	32. b	42. c	52. d
3. c	13. a	23. a	33. d	43. b	53. a
4. c	14. a	24. a	34. a	44. d	54. d
5. c	15. a	25. d	35. a	45. c	55. b
6. b	16. b	26. d	36. b	46. a	56. b
7. b	17. b	27. a	37. a	47. c	57. b
8. b	18. c	28. d	38. c	48. c	58. c
9. b	19. c	29. d	39. a	49. a	59. d
10. a	20. a	30. a	40. d	50. c	60. b

The score for the multiple choice question was determined in accordance with the following scale:

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21

Correct	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40
Score	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40	41

Correct	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60
Score	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60	60

Answer 2 (10 points)

a. Purchase orders may vary in format and style. However, all purchase orders should include areas for insertion of the following information, which was not included in the illustration:

- Price
- Purchase order number
- Purchase order execution date
- Authorization signature

b. In the stores department purchase orders serve to

- Verify that the purchase order was executed as authorized.
- Verify that the quantities reported as received in the receiving department are correct.

In the purchasing department purchase orders serve as

- A control copy of outstanding orders until the order is received.
- A control copy that accounts for the numerical sequence of all purchase orders (to detect unauthorized use).

In the receiving department purchase orders serve to

- Authorize acceptance of specified merchandise.
- Establish an independent verification of quantities received (usually by compelling a blind count).

In the accounting department purchase orders serve to

- Verify that the acquisition was authorized.
- Verify the accuracy of the terms of the vendor's invoice.
- Authorize payment upon proof of delivery.

Answer 3 (10 points)

To the shareholders and board of directors, Fairfax Corporation:

We have examined the balance sheet of Fairfax Corporation as of December 31, 1982, and the related statements of income, retained earnings, and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. The financial statements of Fairfax Corporation for the year ended December 31, 1981, were examined by other independent auditors, whose report dated March 1, 1982, on those statements expressed an unqualified opinion on the balance sheet as of December 31, 1981, and a qualified opinion with respect to the statements of income, retained earnings, and changes in financial position for the year then ended due to an inability to determine the effects on these 1981 financial statements of such adjustments, if any, as might have been determined to be necessary had the January 1, 1981, physical inventory been observed.

In our opinion, the 1982 financial statements referred to above present fairly the financial position of Fairfax Corporation as of December 31, 1982, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Ross, Sandler & Co.

March 17, 1983

Answer 4 (10 points)

Taylor should perform the following additional substantive audit procedures.

- Foot the client-prepared schedule.
- Tie the general ledger accounts payable control account to the client-prepared accounts payable schedule.
- Examine vendors' statements in support of items on the client-prepared schedule.
- Examine other documents (such as approved vouchers) in support of items on the client-prepared schedule.
- Review the general ledger control account for non-cash debits or unusual items, and investigate them.
- Confirm, with positive confirmation requests, account balances from vendors with account balances and vendors with zero account balances.
- Examine unpaid invoices on hand (to ascertain whether any were erroneously omitted from the client-prepared schedule of accounts payable).
- Examine documents in support of invoices paid subsequent to the year end (to ascertain whether the payable was recorded in the appropriate year).
- Inspect receiving reports to (test the accuracy of the year-end cutoff).
- Ascertain whether year-end outstanding checks to vendors were returned with the cutoff bank statement.
- Review correspondence files with respect to disputed items.
- Review open purchase orders for unusual or old items that may have been received but not recorded.
- Examine unmatched receiving reports.

- Make certain that the client representation letter includes the proper assertions concerning accounts payable.

- Investigate and resolve confirmation exceptions and other matters requiring followup.

Answer 5 (10 points)

a. The auditor's objectives during the examination of noncurrent investment securities are to obtain evidence regarding the
- Existence of the investment securities at the balance sheet date.
- Ownership of the investment securities.
- Cost and carrying value of the investment securities.
- Proper presentation and disclosure of the investment securities in the financial statements.
- Proper recognition of interest income.
- Proper recognition of investment gains and losses.

b. The following audit procedures should be undertaken by Kent in order to fulfill the audit objectives referred to above in response to part **a**.
- Inspect and count securities in the company's safe and safe deposit box.
- Examine brokers' statements to obtain assurance that all transactions were recorded.
- Examine documents in support of purchases and sales of investment securities.
- Obtain market quotations for all investment securities as of the balance sheet date.
- Inspect minutes of the board of directors meetings.
- Review the audited financial statements of the (25 percent) investee.
- Verify that the equity method of accounting was used for the carrying value of the investment in Commercial Industrial.
- Obtain a client representation letter that confirms the client's representations concerning the noncurrent investment securities.
- Verify the calculation of interest income.
- Review the propriety of the presentation and disclosure of the securities in the financial statements.

BUSINESS LAW
(Commercial Law)
November 4, 1983; 8:30 A.M. to 12:00 M.

Answer 1 (60 points)

1. a	11. c	21. c	31. d	41. d	51. b
2. d	12. b	22. c	32. d	42. a	52. b
3. a	13. b	23. a	33. c	43. a	53. b
4. c	14. a	24. a	34. a	44. d	54. a
5. d	15. d	25. c	35. b	45. d	55. b
6. c	16. a	26. b	36. c	46. c	56. a
7. c	17. b	27. c	37. a	47. c	57. c
8. c	18. b	28. d	38. c	48. d	58. c
9. d	19. c	29. b	39. b	49. b	59. b
10. c	20. a	30. c	40. b	50. a	60. d

The score for the multiple choice question was determined in accordance with the following scale:

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29

Correct	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40
Score	30	31	32	33	34	35	36	37	38	39	40	41	42	43	44	45	46	47	48	49

Correct	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60
Score	50	51	52	53	54	55	56	57	58	59	60	60	60	60	60	60	60	60	60	60

Answer 2 (10 points)

Part a.

- Zeals has priority over Despard regarding the competing security interests of the parties. Zeals is a purchase money secured party involving the sale of consumer goods. As such, the security interest is enforceable against other creditors of the buyer without the necessity of a filing. Despard would also attempt to assert a purchase money security interest in the goods, but this is questionable at best since the money advanced was obviously not used for the purchase of the goods. Even if Despard qualified as a purchase money secured party, Despard was second in point of time. The fact that it filed does not change the priority, since filing was not required to perfect the interest in the consumer goods (the video system).
- Apache has priority over Despard in this instance. Although Despard was the first to advance credit and qualified as a purchase money lender, it was second in time to perfect its security interest. The subject matter of the sale was equipment, and filing is required to perfect Despard's security interest. The purchase money lender has the benefit of a 10-day grace period for filing. Despard's security interest was not perfected until it filed, which was after the grace period and five days after Apache's filing.

Part b.

1. The instrument in question is a draft and is commonly known as a trade acceptance. Such an instrument arises out of a sales transaction, whereby the seller is authorized to draw upon the purchaser for payment of the goods. Normally, as is the case here, the seller is both the drawer and the payee. The instrument is then presented for the buyer's acceptance.
2. No. The instrument lacks the "magic" words of negotiability on its face. That is, it is not payable to order or bearer but instead payable solely to Hardy & Company. The endorsement on the back of the instrument neither cures the defect nor provides the requisite words of negotiability. Hence, the instrument is not negotiable. The "for value received..." does not in any way affect negotiability.
3. No. Melba would be a holder in due course. He took in good faith and gave value even though the value in question is an antecedent indebtedness. The Uniform Commercial Code specifically provides that an antecedent indebtedness is value. Therefore, Melba as a holder in due course takes free of the so-called personal defenses. Breach of warranty and contractual defenses are personal defenses and a holder in due course such as Melba is not subject to them.

Answer 3 (10 points)

Part a.

1. The principal avoiding powers of the trustee are

- The power to set aside certain statutory liens.
- The power to set aside preferential transfers.
- The power to set aside fraudulent conveyances.
- The power to set aside post-petition transfers.

2. The various claims and assertions would be resolved as follows:

- The claim for an exemption allowance for the cottage will be disallowed. The Bankruptcy Code provides for one exemption for one's principal residence, not to exceed $7,500. The home will qualify for this exemption.

- There is no such rule applicable to business assets as contrasted with personal assets. In fact, there is no distinction between Skidmore and his business, Frock & Fashions. They are one and the same, and all assets will be collected and shared among the creditors without distinction of the source.

- The Bankruptcy Code makes it clear that such conduct would not result in a denial of the discharge of the bankrupt. It will, however, result in the denial of that particular debt from discharge in bankruptcy. Thus, Walton's claim will survive the bankruptcy proceeding.

- A bona fide secured creditor is entitled to the collateral or its monetary equivalent. If this is insufficient to satisfy the loan, the secured creditor has the status of a general creditor for the balance. The priorities section of the Bankruptcy Code provides for no such priority as claimed by Harper.

Part b.

Grant is incorrect in his first three assertions and correct in connection with his fourth assertion for the following reasons:

- The law is clear regarding the right to collateral and its effect between the creditor and the surety. The creditor has the right to resort to any available collateral. Resort to the collateral by the creditor in no way affects the creditor's right to proceed against a surety or sureties for the balance.

- A creditor may choose to sue one or more of the sureties without impairing his rights against those not sued. Similarly, he has the right to sue one surety if he wishes, and such a choice does not release the surety who was not sued insofar as the rights of his fellow surety to seek contribution. Suing one but not all of the sureties does not constitute a release by the creditor.
- All of the defenses asserted in the fact situation are invalid. Grant is a cosurety since he is answering for the same debt as Victory, and there is a right of contribution which Victory may assert against Grant.
- Since Grant's surety undertaking was one-third of the combined surety undertakings, he is liable for \$2,666.67 only and not the full \$4,000.

Answer 4 (10 points)

Bar's lawsuit against Cole will be based upon the intentional tort of wrongful interference with a contractual relationship. The primary requirement for this cause of action is a valid contractual relationship with which the defendant knowingly interferes. This requirement is met in the case of Cole. The contract is not required to be in writing since it is for exactly a year from the time of its making and is therefore valid even though oral. Cole's knowledge of the contract is obvious. The principal problem, however, is damages. Since Bar was the first to successfully market the product, it would appear that damages are not present. It is possible there were actual damages incurred by Bar, for example, it hired another consulting firm at an increased price. It also might be possible that some courts would permit the recovery of punitive damages since this is an intentional tort.

Bar's cause of action against Abel would be for breach of contract. Once again, damages would appear to be a serious problem. Furthermore, punitive damages would rarely be available in a contract action. Finally, Bar cannot recover the same damages twice. Hence, if it proceeds against Cole and recovers damages caused by Abel's breach of contract, it will not be able to recover a second time.

Abel's lawsuit against Cole will be based upon fraud and breach of contract. There were fraudulent statements made by Cole with the requisite intent and possibly to Abel's detriment. The breach of contract by Cole is obvious. However, the contract that Cole induced Abel to enter into and which it subsequently breached was an illegal contract, that is, one calling for the commission of a tort. Therefore, both parties are likely to be treated as wrongdoers and Abel will be denied recovery.

Answer 5 (10 points)

Part a.

1. Dogwood is claiming an easement by prescription resulting from adverse usage.

2. The easement by prescription is the counterpart of obtaining ownership of land by adverse possession. The requirements to establish such an easement are

- Adverse use as distinguished from a permissive usage.
- An open and notorious use.
- Continuous and exclusive use for the time required for the acquisition of title to real property by adverse possession, typically 15 to 20 years.

3. Maple would prevail. Although tacking (adding on) of a prior owner's use is permitted where there is privity, such tacking will not satisfy the first requirement since the use by Acorn of his own land cannot be adverse. Furthermore, the use by Dogwood for five years will not satisfy the statutory time period required for the acquisition of an easement by prescription, typically 15 to 20 years.

Part b.

1. A trust must have a creator (settlor or grantor), trust property (principal, corpus or res), a trustee, and a beneficiary. There must be a writing if the subject matter of the trust is real property.

2. The Crawfords' trust was not created until December 1, 1982, when the land (the res) was conveyed to the trustee in writing. In the case of an intervivos trust of real property with an independent trustee, the settlor (here the Crawfords) must go through whatever formalities (here a conveyance) are required to vest title in the trustee.

3. Yes. Although a trust having a duration of 10 years or more will qualify as a bona fide transferee of property for the purposes of shifting income to the trust or its beneficiaries, a transfer to a trust for a lesser duration will not qualify according to the Internal Revenue Code and Income Tax Regulations. This trust was intended to be what is popularly known as a "Clifford Trust."

4. No. State law precludes, except in rare circumstances, the termination of an irrevocable trust once created. Hence, the Crawfords are stuck with a useless trust for the balance of its term.

ACCOUNTING THEORY
(Theory of Accounts)
November 4, 1983; 1:30 to 5:00 P.M.

Answer 1 (60 points)

1. c	11. a	21. a	31. d	41. d	51. d
2. a	12. c	22. b	32. b	42. b	52. b
3. a	13. a	23. b	33. a	43. b	53. c
4. c	14. d	24. a	34. d	44. b	54. b
5. d	15. d	25. c	35. b	45. d	55. a
6. c	16. d	26. a	36. d	46. c	56. d
7. a	17. b	27. d	37. a	47. d	57. c
8. c	18. b	28. c	38. c	48. b	58. b
9. d	19. d	29. c	39. b	49. c	59. a
10. c	20. a	30. a	40. c	50. b	60. d

The score for the multiple choice question was determined in accordance with the following scale:

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26

Correct	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40
Score	27	28	29	30	31	32	33	34	35	36	37	38	39	40	41	42	43	44	45	46

Correct	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60
Score	47	48	49	50	51	52	53	54	55	56	57	58	59	60	60	60	60	60	60	60

Answer 2 (10 points)

a. Expenditures should be capitalized when they benefit future periods. The cost to acquire the land should be capitalized and classified as land, a nondepreciable asset. Since tearing down the small factory is readying the land for its intended use, its cost is part of the cost of the land and should be capitalized and classified as land. As a result, this cost will not be depreciated as it would if it were classified with the capitalizable cost of the building.

Since rock blasting and removal is required for the specific purpose of erecting the building, its cost is part of the cost of the building and should be capitalized and classified with the capitalizable cost of the building. This cost should be depreciated over the estimated useful life of the building.

The road is a land improvement, and its cost should be capitalized and classified separately as a land improvement. This cost should be depreciated over its estimated useful life.

The added four stories is an addition, and its cost should be capitalized and classified with the capitalizable cost of the building. This cost should be depreciated over the remaining life of the original office building because that life is shorter than the estimated useful life of the addition.

b. The gain should be recognized on the sale of the land and building because income is realized whenever the earning process has been completed and the sale has taken place.

The net book value at the date of sale would be composed of the capitalized cost of the land, the land improvement, and the building, as determined above, less the accumulated depreciation on the land improvement and the building. The excess of the proceeds received from the sale over the net book value at the date of sale would be accounted for as income from continuing operations in the income statement.

Answer 3 (10 points)

a. Michael Company should earn revenue as it performs the work on the contract (the percentage-of-completion method) because the right to revenue is established and collectibility is reasonably assured. Furthermore, the use of the percentage-of-completion method avoids distortion of income from period to period and provides for better matching of revenues with the related expenses.

b. Progress billings would be accounted for by increasing accounts receivable and increasing progress billings on contract, a contra-asset account that is offset against the construction-costs-in-progress account. If the construction-costs-in-progress account exceeds the progress-billings-on-contract account, the two accounts would be shown in the current assets section of the balance sheet. If the progress-billings-on-contract account exceeds the construction-costs-in-progress account, the two accounts would be shown, in most cases, in the current liabilities section of the balance sheet.

c. The income recognized in the second year of the four-year contract would be determined using the cost-to-cost method of determining percentage of completion as follows:

- First, the estimated total income from the contract would be determined by deducting the estimated total costs of the contract (the actual costs to date plus the estimated cost to complete) from the contract price.
- Second, the actual costs to date would be divided by the estimated total costs of the contract to arrive at a percentage completed, which would be multiplied by the estimated total income from the contract to arrive at the total income recognized to date.
- Third, the total income recognized in the second year of the contract would be determined by deducting the income recognized in the first year of the contract from the total income recognized to date.

d. Earnings per share in the second year of the four-year contract would be higher using the percentage-of-completion method instead of the completed-contract method because income would be recognized in the second year of the contract using the percentage-of-completion method, whereas no income would be recognized in the second year of the contract using the completed-contract method.

Answer 4 (10 points)

a. Inventories are presented appropriately as a current asset in the current assets section of the balance sheets.

Cost of goods sold is presented appropriately in the statements of income as a separate item of costs and expenses to arrive at income from continuing operations because it is part of the continuing operations.

Inventories are presented appropriately in the summary of significant accounting policies because the accounting policy regarding inventories, lower of cost (first-in, first-out) or market is disclosed.

Inventories are presented appropriately in the note to financial statements on inventories because the following items are disclosed:

- The composition of the inventories
- The reduction of inventories from cost to market at December 31, 1982, which is an adjustment that, due to its significance, should be adequately disclosed in the notes to the financial statements
- The fact that the cost of inventories at December 31, 1981, approximated their market value.

b. 1. The components of the quick (acid-test) ratio are as follows:

- The quick assets that make up the numerator are cash, short-term marketable securities, short-term notes receivable, and accounts receivable. In the Pace Company current assets section of balance

sheets it would be the cash, the marketable securities, and the accounts receivable.
- Total current liabilities is the denominator.

2. The quick (acid-test) ratio tests the ability to meet sudden demands upon liquid current assets. It is used as a test of immediate liquidity by short-term creditors and others.

c. The provision for deferred income taxes should not be included in the statements of income in "other-net." Deferred income taxes are part of income taxes and should be presented in the statements of income in "income taxes."

The breakdown between current income taxes and deferred income taxes should be presented in the statements of income or disclosed in the notes to the financial statements. If the breakdown between current income taxes and deferred income taxes is disclosed in the notes to the financial statements, it should be disclosed in the note on deferred income taxes, not in summary of significant accounting policies.

d. The accounting change is a change in estimate, not a change in principle and should not be included in the statements of income separately as "cumulative effect, less applicable income taxes of $1,500,000." The effect of the change should be reflected in depreciation expense in the current and future years as a separate component of income from continuing operations before income taxes because it is a material event that is usual but infrequently occurring. "Income taxes" should be adjusted each year. A separate per share amount for this change should not be presented in the statements of income under "earnings per share of common stock."

Answer 5 (10 points)

a. A lease should be classified as a capital lease when it transfers substantially all of the benefits and risks inherent to the ownership of property by meeting any one of the four criteria established by FAS 13 for classifying a lease as a capital lease.

Lease J should be classified as a capital lease because the lease term is equal to 80 percent of the estimated economic life of the equipment, which exceeds the 75 percent or more criterion.

Lease K should be classified as a capital lease because the lease contains a bargain purchase option.

Lease L should be classified as an operating lease because it does not meet any of the four criteria for classifying a lease as a capital lease.

b. For Lease J, Borman Company should record as a liability at the inception of the lease an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term, excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon. However, if the amount so determined exceeds the fair value of the equipment at the inception of the lease, the amount recorded as a liability should be the fair value.

For Lease K, Borman Company should record as a liability at the inception of the lease an amount determined in the same manner as for Lease J, and the payment called for in the bargain purchase option should be included in the minimum lease payments.

For Lease L, Borman Company should not record a liability at the inception of the lease.

c. For Lease J, Borman Company should allocate each minimum lease payment between a reduction of the liability and interest expense so as to produce a constant periodic rate of interest on the remaining balance of the liability.

For Lease K, Borman Company should allocate each minimum lease payment in the same manner as for Lease J.

For Lease L, Borman Company should charge minimum lease (rental) payments to rental expense as they become payable.

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AICPA, Statement of Position no. 78-4, *Application of the Deposit, Installment,* and *Cost Recovery Methods in Accounting for Sales of Real Estate* (AICPA, 1978), pp. 9–10.
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